

CHAPTER 11 - 101 THE NUTS AND BOLTS OF CHAPTER 11 PRACTICE: A PRIMER

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Welcome to the Jungle

Editors' Note: *This is one of 22 installments that are being published here, with permission from the American Bankruptcy Institute. The series, read consecutively, will give the reader a broad overview of the chapter 11 bankruptcy process. The installments are chapters from a CD-Rom that is available for purchase for \$20 (\$10 to ABI members) through the ABI. For more information, you can call the ABI at (703) 739-0800 or go to www.abiworld.org. The authors welcome your comments and questions as well, and you may feel free to contact them. Jonathan Friedland is a member of the ABI Board of Directors as well as a member of NACM Oregon.*

The overwhelming majority of bankruptcy cases involve debtors who have no assets to distribute to creditors and who are filing just to get the discharge. Well over a million and sometimes over two million such cases are filed each year. These are important cases for the people involved, and they provide work for a lot of lawyers. But they aren't our department, and we won't spend a lot of time on them. Instead, we will spend most of our time on the cases where the debtor does have assets, and where the goal is to "reorganize" (whatever that may mean—of which more will be discussed later).

Bankruptcy law is federal. It is federal because in Article I of the Constitution it says that Congress shall have the power to make bankruptcy law. Congress exercised the power through the Bankruptcy Reform Act of 1978 (BRA), including the Bankruptcy Code, which is codified in Title 11 of the U.S. Code. The bankruptcy code was most recently amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), applicable to all cases filed after October 17, 2005.

The BRA creates bankruptcy courts that operate as "a unit of" the U.S. district courts. Formally, the big distinction is in the power of the judge: the district judge exercises his judicial power under Article III of the Constitution and is a lifetime appointee, while the bankruptcy judge is a term appointee (14 years), deriving his or her power from the bankruptcy clause in

Article I of the Constitution. Because the bankruptcy judges are "Article I" judges, case law holds that there must be limitations on the power of a bankruptcy judge in order for the bankruptcy system to be constitutional.

As a result, Title 28 of the U.S. Code was amended to put the bankruptcy judge under the "supervision" of the district judge: certain decisions by a bankruptcy judge must be reviewed by a district judge, and the district judge can withdraw matters that are pending before the bankruptcy judge and instead decide them herself. But practically speaking, the overwhelming majority of what happens in bankruptcy cases takes place in the bankruptcy court, under the supervision of the bankruptcy judge.

Who are the players in the bankruptcy game?

We have already mentioned the bankruptcy judge; he or she presides over the bankruptcy court. There are about 340 bankruptcy judges around the country, give or take. Some came to the bankruptcy bench with a lot of bankruptcy experience, some did not. But it may not make much difference: Lots of those without bankruptcy experience are fast learners, and some of them brought valuable experience from elsewhere—*e.g.*, good trial skills.

As with other judges, the relationship between bankruptcy lawyers and judges is a somewhat formal one. You typically deal with them either in court, on the record or through their staff. Local practice may vary somewhat, but the chances are that the judge has a secretary, a "courtroom deputy" who manages scheduling and the flow of paper, and a law clerk. Some bankruptcy judges have opted for two clerks and no secretary. Tastes differ on how you communicate with the court: Some want you to work through the secretary, some through the deputy and some through the law clerk.

In addition to the bankruptcy judge's staff, bankruptcy attorneys also typically deal with the clerk of the bankruptcy court and the clerk's staff. The

clerk's office is in charge of filing papers, assigning cases and, in some courts, scheduling matters. Because bankruptcy involves so much paperwork (and because of the high volume of cases), the clerk of the bankruptcy court plays an important role. A good clerk's office can make the bankruptcy process work much more smoothly for the judges and the lawyers alike.

As a matter of law, the court is always open. This is why you sometimes see major bankruptcy cases filed on Sundays or holidays. The clerk will meet you there and accept the filing if necessary. This is one more good reason to develop a good working relationship with the bankruptcy clerk's office.

In the mass of ordinary bankruptcies (the "Chapter 7 cases" discussed below), the case is administered by a trustee. The trustees are selected in rotating order from a "panel" of local trustees—typically lawyers, but sometimes accountants or other financial professionals. The trustee collects and liquidates the debtor's nonexempt assets (although, as noted above, in most cases there are not any). He is generally empowered to "police" the case. Sometimes, the trustee hires lawyers to represent him.

In Chapter 13 cases, in which an individual proposes a plan to repay at least a portion of his debts over, normally, a five-year period, the standing Chapter 13 trustee for the district will collect and administer payments under the plan as well as participate in the administration of the case. The standing Chapter 13 trustee is different than the "panel" trustees who handle Chapter 7 cases.

Chapter 11 is different. There is no trustee unless the judge orders the appointment of one. In lieu of a trustee, the debtor remains in control of its business and assets as debtor-in-possession (DIP). The DIP has most of the powers and responsibilities of a trustee. There are many instances where a particular power will belong either to the trustee or to the DIP, depending on who is in charge. To simplify matters, in this book we will use "DIP" to refer to the entity in charge of the Chapter 11 estate.

In the typical case, it is the debtor who initiates the bankruptcy case through its (pre-bankruptcy) lawyer. Once it has filed, the debtor—now DIP—seeks court approval to retain its lawyer as counsel for the DIP. The DIP's counsel becomes a kind of "point person" in the Chapter 11 case.

Do not confuse "case" trustees with the "United States Trustee." The U.S. Trustee for any given "region" is the head of the Office of the U.S. Trustee (the UST) for that region. The UST is a division of the

Department of Justice that is charged with oversight of the bankruptcy system. The U.S. Trustee's Office appoints and supervises panel trustees, appoints official committees (see below), reviews and comments on applications to employ and compensate professionals, investigates bankruptcy fraud and abuse, and can be heard on any other issue in a bankruptcy case. The UST is often active in the very early stages of a Chapter 11 case, although once the case is up and running, and particularly if there is active creditor participation, the UST often backs off a bit. In two states (Alabama and North Carolina), there is a Bankruptcy Administrator rather than a UST, but the duties are essentially the same.

In large Chapter 11 cases, you will also have a "committee"—an official committee of unsecured creditors, appointed by the UST. The committee typically consists of the five or seven largest unsecured creditors that are willing to serve. It hires counsel (and sometimes financial advisors or other professionals) who are paid for by the debtor's estate. The committee has standing to be heard on any issue in a Chapter 11 case, and its views tend to be taken seriously by the bankruptcy judges. An active and well-represented committee can play a major role in the outcome of the case. In some cases, other official committees will also be appointed, such as Equity-holder Committees, Retiree Committees, Bondholder Committees, etc. Unofficial committees, neither appointed by the U.S. Trustee nor necessarily paid for by the estate, may also form and be active in a case.

Other important players include secured parties, especially banks, that may have liens on substantially all of a debtor's assets, and counter-parties to executory contracts. Due to the nature of modern business financing, secured creditors are extremely important to the process, and without their consent and cooperation many Chapter 11 debtors are forced to shut their doors.

Now, a word about the structure of the Code. As we said above, the Bankruptcy Code is in Title 11 of the U.S. Code and is divided into chapters. Chapters 1, 3 and 5 are "general" chapters, applicable in all cases:

- Chapter 1 contains definitions, delineates who can be a debtor, describes the courts' powers and contains some other general rules.
- Chapter 3 governs "case administration," including matters such as the filing of new cases, employment of professionals, the automatic stay, the use, sale and lease of estate assets, post-petition financing, executory contracts, the dismissal and closing of cases, and some other matters.

- Chapter 5 covers a wide variety of matters relating to the rights of debtors and creditors, including claims and priorities, matters relating to exemptions and discharge of debts, and the “avoidance” provisions, which permit a DIP to claw back certain transfers made prior to the petition date.

Chapter 7 provides additional rules for cases in which a trustee liquidates the assets. Both individuals and business entities can be Chapter 7 debtors. Corporate Chapter 7 debtors are just liquidated and do not get a discharge (they don’t really need one; liquidated corporations are not usually attractive defendants). Individual Chapter 7 debtors turn over their nonexempt assets (if any) to the trustee, and then ordinarily get a discharge, which covers most (but not all) kinds of debts. Earnings from personal services do not become part of the bankruptcy estate in Chapter 7.

Chapter 13 provides additional rules for cases in which the debtor agrees to submit a portion of his post-petition earnings to pay pre-petition debts. In return he gets protection against creditor action, and a chance to restructure some of his pre-bankruptcy debts. Probably most Chapter 13s are filed by individuals seeking to protect their homes against the threat of a mortgage foreclosure. Others are filed by debtors with assets that they would lose in Chapter 7, but that they may keep if they carry out a Chapter 13 plan. Chapter 13 debtors also get to discharge some debts that might not be dischargeable in Chapter 7, although the Chapter 13 discharge isn’t as broad as it was before the BAPCPA amendments, and it probably isn’t a factor in most Chapter 13 filings. Due to the fact that under a Chapter 13 plan, the debtor’s finances (other than those necessary for basic life expenses) are devoted to plan payments, any substantial negative economic event—such as being injured and unable to work or losing a job—is likely to cause a default under the plan and a conversion of the case to Chapter 7.

Chapter 11, entitled “reorganization,” is the chapter that provides additional rules for the small number of “big” business reorganizations that entail a lot of lawyer time and effort, and generate a lot of professional fees. If you ask a Chapter 11 lawyer what it means to reorganize, she will likely say something like this: A Chapter 11 case allows the debtor to preserve the business as a going concern, and thereby to maximize value for creditors, shareholders, employees, and other stakeholders.

This is a beguiling picture and not entirely true; there are all kinds of difficulties:

- The most obvious is that not all businesses are worth more as a going concern than they are in liquidation. A notorious example is the case of the Penn Central Railroad, one of the largest bankruptcies in American history. Penn Central went into bankruptcy as an unprofitable network of railroads, then emerged as a valuable real estate company.
- A second difficulty is that Chapter 11 specifically provides that a reorganization plan may provide for the liquidation of some or all of the debtor’s assets—so Chapter 11 is not only about reorganization, and the Code implicitly recognizes that in some cases value is maximized through liquidation.
- Third, the debtor does not need to choose Chapter 11 if he wants the business to continue; the trustee may, with court approval, continue to operate the business in Chapter 7 (although it is not often done).
- Fourth, the distinction between “liquidation” and “going concern” may be less clear in practice than it is in theory. One can perfectly well “liquidate” a business by selling it as a going concern, in which case the distinction does not mean anything at all. Indeed, the “going concern” sale is a popular trend these days.
- Finally, bankruptcy law conflates two concepts that are overlapping but fundamentally quite different. One is the notion of maximizing the value of the assets. The other is the notion of saving the residual stake of the pre-bankruptcy owners. This confusion is apparent in the classic Chapter 11 case. The old residual owners (equity-holders), still in control of the enterprise, will file the petition. They will remain in control (as DIP) and will propose “a plan” to “save the going concern.” If all goes well, the effect will be to maximize the payout to creditors and to leave something on the table for the owners (while preserving jobs, generating future tax revenues and serving other social goods that are often touted as benefits of reorganization). Such a scenario appears to be a self-evident win-win situation. But it is rarely that simple. “Saving the going concern” means continuing the business, which means continuing to bear risk. Where the business is insolvent, equity always gains from taking risks: Liquidate today, and they get nothing; keep the business going, and they may have a chance. Creditors tend to be correspondingly risk-averse: Liquidate today, and they get paid. Take a gamble, and the rewards go to equity, while the creditors bear the risk of loss. The point is not that creditors always favor

liquidation—clearly, they don’t—but the risk-reward calculation is different for creditors than it is for equity-holders (and it is similarly different for junior creditors than it is for senior creditors). There can be no doubt that Chapter 11 obscures, rather than resolves, this tension—almost as if deliberately to allow the court to choose, from case to case and even from time to time within a case, whether “assets” or “equity” will dominate.

Aside from Chapters 7, 11 and 13, there are a couple of other chapters for particular kinds of cases. Chapter 9 is for municipalities (the cases are few in number, but sometimes notorious). Chapter 12 is for “family farmers or fishermen” (but plenty of farmers and fishermen use Chapters 11 or 7). A new “Chapter 15” governs cross-border insolvencies. It isn’t really a full-dress bankruptcy device like the other chapters: rather it is a mechanism for orchestrating the competition between jurisdictions. It supplants former § 304.

Aside from the Code, there are other places to look for bankruptcy law. The jurisdiction provisions are in Title 28 of the Judicial Code. There are some provisions on bankruptcy crimes in Title 18, the Federal Criminal Code. There is some bankruptcy tax law in Title 26, the Internal Revenue Code.

But there is still more law. In a great many cases, the bankruptcy court is adjudicating rights that involve “other law”—*e.g.*, the non-bankruptcy law of property. So, the bankruptcy lawyer may have to be an expert, or at least versed, at this other law. At a minimum, he needs to be able to spot the issues and know when to call in the specialists. In any particular case, this can mean anything. Most often, it means non-bankruptcy debtor-creditor and commercial law, notably Article 9 of the Uniform Commercial Code (secured transactions in personal property) and non-bankruptcy mortgage law.

Aside from the statutes, there is a set of Federal Rules of Bankruptcy Procedure, a cousin to the Federal Rules of Civil Procedure. And bankruptcy courts also have their own local rules, which should be (but are not always) consistent with the more general bankruptcy rules. Most bankruptcy courts have websites, and the local rules are generally available on the websites. The official forms can be found at <http://www.uscourts.gov>.

One final note: on April 20, 2005, the President signed into law the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Public Law 109-8, 119 Stat. 23, which made the most wide ranging and substantial changes to the Bankruptcy Codes since it was enacted in 1978. In this book, that act is referred to

as BAPCPA and citations to it or its effects on the Code are given to the Code section, not the original BAPCPA provision.

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(Watch for next month’s issue—“The Life Cycle of a Chapter 11 Debtor Through the Debtor’s Eyes”