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CONSUMER BANKRUPTCY

What The General Practitioner Should Know About Chapter 11

Part I

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With our turbulent economy, even established businesses may find it difficult to cope with their ever increasing trade debt, pay their taxes, and deal with secured creditors. An option available to a financially troubled company is to seek protection afforded by a bankruptcy reorganization. Chapter 11 enables a business to obtain protection from its creditors while it attempts to reorganize its debts and pay them off, at least partially, over a period of time. Chapter 11 relief is available to virtually any business whether it is a sole proprietorship, partnership or corporation.

Scope of This Article. Many of my previous articles focused on consumer bankruptcy practice and procedure. Chapter 11 business bankruptcy, however, is infinitely more complex than consumer bankruptcy, and is not recommended for the casual bankruptcy practitioner.

Competent representation of a business in reorganization requires a thorough knowledge of the entire bankruptcy code and local rules, together with a keen understanding of local chapter 11 practice and procedure. Therefore, this article will provide an overview of what chapter 11 is about, to better enable you to adequately advise your small business clients as to whether chapter 11 should be considered as a viable option, and if so, what may be expected. In the event chapter 11 looks like a distinct possibility for your client, consider referring your client to a bankruptcy attorney. I will present this article in a three-part series.

Comparison With Other Chapters. Consumers utilize chapter 7 to eliminate most debts, and they generally use chapter 13 to keep real estate and stop foreclosure while paying off their debts with a payment plan. Individuals who ordinarily would file chapter 13, but are prevented from doing so because they have more than $290,525 in

unsecured debt or more than $871,550 in secured debt, can utilize chapter 11. Corporations may file chapter 7 as a means of orderly dissolving a debt-ridden corporation that does not want to continue operating. Any significant assets of a corporate chapter 7 debtor are liquidated by a trustee. Corporations may not file chapter 13.

Situations Where Chapter 11 Is Beneficial. Unfortunately, most chapter 11 proceedings are filed only after a company has gotten so seriously into debt that it can barely continue functioning, or the company may be facing a creditor who is threatening to take drastic collection action. In advising a financially troubled company, you should explain that bankruptcy considerations should not be put off too long while the principals of the company hope that business will turn around. Instead, a bankruptcy filing should be taken as a more preventative measure at the early signs of financial difficulty, rather than as an emergency measure done under extreme pressure.

Perhaps the most common situation in which a company is forced to quickly file chapter 11 is when numerous trade creditors have already begun significant collection activity, which may include the initiation of law suits or the enforcement of judgments. Another common emergency situation is when one of the taxing authorities threatens to levy a bank account or padlock the door. Pressure from secured creditors to repossess key equipment, or from a mortgagee to foreclose business property, are also reasons to seek immediate chapter 11 protection. Sometimes a bankruptcy reorganization may be used for less apparent reasons, such as to terminate a highly unprofitable lease or contract.

The Chapter 11 Petition. The petition is essentially similar to the official form used in chapter 7 cases. Thus, the debtor must list all of its creditors and amount of debts; list all assets and property; set forth a statement of income and expenses; and disclose pertinent financial information. In addition, there is a schedule of the "top twenty" largest debts owed to non-insider creditors; an exhibit setting forth whether the shares of stock are registered with the S.E.C., and who the majority shareholders are; a schedule of all equity shareholders; and a corporate resolution authorizing the retention of the bankruptcy attorney and the filing of the chapter 11 proceeding.

In addition, local rules require an affidavit from an officer of the debtor setting forth the estimated weekly payroll and operating expenses for the thirty day period following the filing of the petition, the estimated gain or loss in the operation of the business during this period, and information that will fully inform the court as to the desirability of the debtor continuing business.

Emergency Filings. A chapter 11 petition can be filed in an emergency by filing a skeletal petition. The remaining documents must be filed within a period of two to fifteen days, depending on the document. Chapter 11 petitions must be filed electronically.

The Chapter 11 Attorney. An attorney representing a chapter 11 debtor must be authorized by the court to represent the debtor. In addition, once the petition is filed, the attorney is not entitled to earn any legal fees until the court issues a written order authorizing the attorney to represent the debtor.

For this reason, the bankruptcy attorney will prepare a "first day" application and order requesting approval to be retained by the debtor. The application, which is submitted on the first day of the bankruptcy, must set forth the attorney's previous chapter 11 experience and qualifications, as well as the attorney's hourly rates. In addition, the attorney must submit an affirmation of disinterest indicating that he or she represents no interest adverse to the debtor or the bankruptcy estate.

Legal Fees. Because of the extensive amount of work involved in chapter 11 proceedings, legal fees tend to be rather substantial. Virtually all chapter 11 attorneys are compensated on an hourly fee basis. The attorney will usually request a sizable retainer that is paid prior to filing. The amount may depend on the size and volume of the debtor's business, the number of creditors and amount of debt owed, the attitude and aggressiveness of the creditors, and the extent of issues requiring litigation.

A typical retainer for a small business reorganization is usually $10,000 and up. Most bankruptcy attorneys will also require the principals of the business to personally guarantee the legal fee.

One of the reasons that a large retainer is necessary is because the attorney may not receive any additional legal fees unless authorized by the court. The bankruptcy rules limit the number of fee applications the attorney can make. Thus, once the petition is filed, the attorney will not see any additional legal fees for many months, if at all.

The bankruptcy court takes a very active role in monitoring the legal fees paid by the debtor. Therefore, the fee application itself is a rather involved process requiring a court hearing. The court will only compensate attorneys for necessary legal work, and then, only in an amount which is reasonable. Scrupulous time records are necessary to substantiate the legal work performed. Many attorneys have been criticized by the court for failing to keep proper time records and have suffered accordingly. Some judges are particularly notorious for imposing elaborate record-keeping requirements on counsel.

Court Fees. The current filing fee for chapter 11 is $839. In addition, there are quarterly fees payable to the United States Trustee until the case is confirmed, based on the amount of the debtor's disbursements.

The Automatic Stay. As with all bankruptcies, an automatic stay pursuant to Bankruptcy Code section 362 goes into effect immediately upon filing the petition. The automatic stay acts as an injunction to stop all foreclosures, collection actions, civil litigation, and creditor harassment. The stay applies to all creditors including taxing authorities.

Moratorium on Paying Debts. The debtor does not have to pay most pre-petition debts for a period of several months, until the payment plan is confirmed. However, the debtor may have to pay something towards certain debts, such as rent or arrears on secured debt, under certain circumstances. This breathing time is essential to permitting the debtor to concentrate on becoming a more profitable entity.

First Day Orders. A debtor must obtain court permission to retain any professionals (such as the bankruptcy attorney), or engage in certain conduct. Since such court permission is necessary immediately, the bankruptcy attorney will prepare a number of applications and orders which are immediately presented to the designated judge on the day the bankruptcy is filed. These urgently needed court authorizations are referred to as first day orders. Although such relief is requested ex-parte, a judge will frequently direct counsel to serve all creditors, or certain parties in interest with the application and order, and will permit these parties to later oppose a continuation of the requested relief at a hearing.

Other situations that may require first day orders include applications to pay pre-petition wages, use cash collateral, continue existing bank accounts, employ an accountant, or sell assets outside the ordinary scope of business.

How Creditors Are Notified. About three days after the case is commenced, the court will mail all creditors an official notice of filing which will also set forth the judge, court, name of debtor's attorney, and date for the first meeting of creditors. In addition, the court also sends a blank proof of claim form which the creditor may use to file a claim.

Editor's Note (revised 2008): Craig D. Robins, Esq., a regular columnist, is a bankruptcy attorney who has represented thousands of consumer and business clients during the past twenty years. He has offices in Medford, Commack, Woodbury and Valley Stream. (516) 496-0800. He can be reached at CraigR@CraigRobinsLaw.com. Please visit his Bankruptcy Website: CraigRobinsLaw.com.