CHAPTER 11 BANKRUPTCY CASES: EVALUATING A SECURED CREDITOR'S POSITION

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The COVID-19 pandemic had a significant impact on businesses in 2020 — bankruptcies increased in the fourth quarter with an expectation of more to come in 2021. One report, which tracks the increase or decrease in Chapter 11 bankruptcy filings with more than $1 million in assets, predicts more distress throughout this year.

In this article, we discuss Chapter 11 bankruptcy and how to evaluate a secured creditor's position in this type of bankruptcy.

WHAT IS A CHAPTER 11 BANKRUPTCY?

The purpose of a Chapter 11 case is to provide a debtor that cannot pay all its obligations when due with an opportunity to reorganize its debt and continue operating. This is achieved through the preparation, confirmation, and implementation of a plan of reorganization. This is different from a Chapter 7 case, which focuses on liquidation.

A debtor that continues to operate under Chapter 11 is called a "debtor in possession" or DIP. The DIP — with permission from the Bankruptcy Court — can have use of its property after filing of the bankruptcy case, unlike the debtor in Chapter 7 bankruptcy.

To file for Chapter 11 bankruptcy, the debtor may be a corporation, a limited liability company, sole proprietorship, or a partnership.

The filing can either be voluntary, where the case is commenced by the debtor, or involuntary, where the debtor is forced into bankruptcy by its creditors. If the plan of reorganization cannot be confirmed — for reasons such as creditor objection or not being feasible — then the case will either be dismissed or converted to Chapter 7.

CHAPTER 11 KEY PLAYERS

The key players in the Chapter 11 bankruptcy process are the following:

- The Debtor in Possession (DIP) – This refers to the debtor who will continue operating the business after the Chapter 11 petition has been filed. The DIP is a fiduciary and has all the rights and powers of a Chapter 11 trustee. It must follow all the trustee's duties set forth in the Bankruptcy Code and Bankruptcy Rules, such as accounting for property, filing informational reports, examining and objecting to claims, filing monthly operating reports, etc. With the court's approval, the DIP can also employ professionals such as attorneys, accountants, and appraisers.

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- The U.S. Trustee – As a component of the Department of Justice, the U.S. Trustee monitors the progress of the Chapter 11 case and supervises its administration. The U.S. Trustee (or a representative of the U.S. Trustee) will also conduct a meeting of the creditors known as "Section 341 meeting." Creditors may appear at this meeting and ask the debtor questions about its conduct, property, and administration of the case.
- Secured Creditors – Creditors that are owed by the debtor and have an underlying security interest in the debtor's assets. The amount of a secured claim would depend on the value of the interest in the lien on the collateral.
- Unsecured Creditors – Creditors that are owed by the debtor and have no underlying security interests in the debtor's assets.
- The Creditors' Committee – This committee is appointed by the U.S. Trustee and consists of unsecured creditors who hold the seven largest unsecured claims against the debtor. These creditors act in representative capacity for the entire general unsecured creditor body and are entrusted to make important decisions for the group. The committee may hire professionals to represent them and it plays an important role in the Chapter 11 case.
- DIP Lender(s) – The debtor usually cannot generate enough cash to fund its operations and, as such, needs outside funding. DIP lender(s) agree to extend a loan to the debtor in order for it to continue its operations. Usually, DIP lenders(s) obtain favorable terms in return.

CHAPTER 11 CHRONOLOGY

There are several significant events that unfold during a Chapter 11 case.

First-day motions

Upon filing the case, debtor's counsel will submit what are known as "first-day motions". These motions ask the court to allow the debtor to continue certain actions — such as using a secured creditor's "cash collateral", paying employees and suppliers, etc. while the debtor continues to operate.

Section 363 of the Bankruptcy Code defines cash collateral as "...cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents..." in which the estate and another entity (a creditor) has an interest and includes the proceeds thereof. The debtor can only use cash collateral with permission of the Bankruptcy Court or the creditors' consent. The affected secured creditor would need to be offered "adequate protection" – such as interest payments or alternate assets as collateral.

DIP financing

The debtor will utilize the bankruptcy process to obtain DIP financing (access to capital through additional borrowing) and the DIP will continue operating its business until the Plan of Reorganization is confirmed.

Sometimes a secured creditor may prefer to serve as a DIP lender and as such would need to undergo a thorough due diligence process.

For due diligence involved in DIP financing, read Due diligence in bankruptcy: DIP financing and section 363 sales.

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Formation of the Official Committee of Unsecured Creditors

The U.S. Trustee will form the Official Committee of Unsecured Creditors. This is just as it sounds — a committee of creditors who don't have collateral to secure the debt they are owed. These creditors have certain rights in a Chapter 11 bankruptcy case.

Assumption/Rejection of leases

To help the debtor reorganize, this is the process of assuming or rejecting certain leases, such as real estate leases and those for certain equipment.

Filing of a Plan of Reorganization and Disclosure Statement

The debtor will file a Disclosure Statement together with the Plan of Reorganization.

The Disclosure Statement provides detailed information concerning the business affairs of the debtor, including its' assets and liabilities.

Remember that the goal of a Chapter 11 case is for the debtor to reorganize. To that end, the debtor must come up with a Plan of Reorganization – a map that will detail how the debtor will discharge some debts and will restructure its operations so that it can emerge from the Chapter 11 case and continue operating in the ordinary course.

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The Plan of Reorganization will include a classification of the claims and how each class of creditors will be treated. The typical classes of claims in the order of priority are:

- Secured creditors
- Priority unsecured creditors
- General unsecured creditors
- Equity security holders

Prior to its filing, the Plan of Reorganization will typically be subject to negotiation among the debtor and its creditors and will follow Bankruptcy Code guidelines. Both the Plan of Reorganization and the Disclosure Statement require Bankruptcy Court approval.

Voting on the Plan

The creditors will then vote on the Plan of Reorganization. Once the creditors vote in favor of the plan, the Bankruptcy Court will confirm the plan, and the debtor will then "emerge" from the Chapter 11 case. Sometimes, the plan can be confirmed over the objection of a class of claims – this is known as a "cramdown." In a cramdown, at least one "impaired" class must vote in favor of the plan.

CHANGES TO A SECURED CREDITOR'S POSITION

A plan may sometimes alter a secured creditor's position by offering substitute collateral or subordinating the secured creditor's lien to a new lender, such as a DIP lender. This is allowed under the Bankruptcy Code, provided that the secured creditor is afforded "adequate protection" against loss. Some examples of "adequate protection" include monthly payments, casualty insurance, or a lien on other property of the estate. Anything else may be acceptable so long as it will assure that the creditor receives the "indubitable equivalent" of its secured claim.

Sometimes the Bankruptcy Court exercises its power to "equitably subordinate" perfected secured debts — meaning, assign a lower payout priority to certain secured claims. Because Bankruptcy Courts are courts of equity, they have the capacity to balance the equities in a case by relying on principles of fairness. For example, a court may subordinate security interests of the insiders of the debtor who would have had either preferential treatment or access to information that other creditors did not. Decisions in these types of cases are very fact specific.

EVALUATING THE SECURED CREDITOR'S POSITION IN A CHAPTER 11 CASE

To help ensure that your client's claim receives the necessary attention and treatment in a Chapter 11 bankruptcy case, it's important to take into consideration the below steps.

Confirm the claim amount

If you represent a secured creditor in a Chapter 11 case, you have a duty to perform proper due diligence, and as such, it is advisable to review all substantiating evidence in support of the claim when determining the claim amount.

Confirm status of perfection

This can be accomplished by running lien searches in the jurisdiction of the debtor's organization and confirming that lien filings follow UCC or other applicable rules. Remember that under the UCC, a registered organization's name must be the name that is listed on the "public organic record." To obtain the true legal name of the debtor, it is best practice to request the entity's formation documents from its jurisdiction of organization. The debtor name on a UCC filing must match the formation documents and any amendments thereto, including all spelling and punctuation.

Review status of other liens

If your client does not hold a first position lien, it is a good idea to confirm that any lienholders that come ahead of your client are indeed perfected. Again, this can be accomplished by running lien searches.

File a proof of claim

If you agree with how the debtor listed your claim in its schedules, you are not required to file a proof of claim in a Chapter 11 case.

However, it is a best practice to do so to avoid any unanticipated changes; either to the claim amount (which can be amended) or otherwise. The proof of claim must be filed by the deadline set by the Bankruptcy Court.

Evaluate the collateral

Consider retaining appraisers or other professionals to evaluate the collateral securing your client's claim and any potential risk to that collateral. Should the collateral be subject to threat of losing its value, your client is entitled to "adequate protection" against losses, and you would want to ensure that any proposed "protection" is in fact adequate.

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Determine whether the value of the collateral exceeds the amount of the claim

If it does, you may also ask for interest and attorney's fees with your client's claim. However, if the value of the collateral is less than the amount of the claim, your client is deemed to be undersecured, and the claim cannot accrue interest (and naturally there will not be enough money to pay attorney's fees).

Review Plan of Reorganization

Lastly, review how your client's claim is classified in the Plan and ensure that it reflects the secured status.

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