Chapter 11 filing are pursued while the bankruptcy preparation ensues, and potential debtors often end up not filing for bankruptcy due to the implementation of one of these other options.

The second stage consists of the first days and weeks of the bankruptcy case. These days are full of activity and occupy a great deal of management’s time, and a great number of lawyer hours.

The third stage is the “middle” of the chapter 11 case. This can be a relatively slower period of activity, and a debtor’s management typically can focus on business operations again. But because of the restrictions placed on a debtor by the bankruptcy laws, chapter 11 is never completely “business as usual.” A debtor must still consult with counsel on a myriad of issues, and will spend a lot of time negotiating, and perhaps litigating, with interested parties. The fourth stage, which we will address in our next column, is the rest of the case. Most of the activity in this stage relates to the exit from chapter 11, usually either by a reorganization plan or by sale of assets.

Preparation Stage

The chapter 11 proceeding brings with it certain important protections that arise immediately upon the filing of the petition, most notably the automatic stay of §362. However, with these statutory protections come restrictions that limit a debtor’s unfettered discretion to operate without court approval.

Debtor’s counsel typically seeks a number of orders in the first days of the case in an effort to minimize the disruption caused by chapter 11. Certain of these “first-day orders,” as they are called, are designed to override statutory prohibitions of the Bankruptcy Code. For example, the Code generally prohibits a debtor from paying any pre-petition debts, so a debtor may file a motion seeking permission to pay pre-petition employee wages or pre-petition claims of critical trade vendors. Other first-day orders are sought to take advantage of powers uniquely given to a debtor in bankruptcy. For example, a motion to reject executory contracts may be filed as a first-day motion. Yet other first-day orders must be procured either out of administrative necessity or to seek modification of specific Bankruptcy Code requirements. Examples include applications to retain professionals, motions to procedurally consolidate related cases, and motions to maintain current bank accounts and cash management procedures. Finally, debtors will often file first-day motions to assure the availability of cash, including motions for authority to use a secured creditor’s “cash collateral” and a motion for approval of post-petition

financing. The relief that debtors request on the first day varies depending on the debtor's needs and the willingness of the court to grant the kinds of relief the debtor would like to have.

The drafting of first-day motions is typically preceded by a period of due diligence by debtor's counsel. Counsel must establish debtor contacts, and appropriate measures must be implemented to ensure confidentiality of the bankruptcy-related discussions. At this early stage in the bankruptcy preparation process, a great deal of discretion must be exercised because often only a limited group of the debtor's employees are aware that a bankruptcy filing may be imminent. If word of an impending bankruptcy filing leaks out, it can lead to serious adverse consequences—vendors may cease shipping, other creditors may seek to exercise remedies, competitors may seek to take away business, customers may look elsewhere, and employees may hit the street looking for a more secure job. As a result, the employees who are best equipped to provide counsel with the information it needs are sometimes unavailable. More generally, a debtor may be operating with a significantly reduced workforce, further limiting the debtor's resources available to assist in preparing for bankruptcy.

The First Days of a Case

A chapter 11 case may be commenced on a voluntary or involuntary basis. Although most of what we say here is applicable to involuntary cases as well, involuntary cases will be the focus of a future column.

A company (or individual, but for ease, we say “company” throughout) commences a voluntary chapter 11 case by paying the requisite filing fee and filing a petition for bankruptcy. The drafting of first-day motions is true emergencies, but some are not. It is good practice to call something an “emergency” only if it really is one; the “first-day hearing” is counsel’s first chance to gain—or lose—credibility with the judge, and that credibility is your—and perhaps your client’s—greatest asset.

The first days of a case can be quite time-consuming for a debtor’s management. To begin with, representatives of the debtor must be present at the hearings on the first-day motions. Moreover, inquiries from customers, suppliers, creditors, investors, employees and sometimes the media abound. At the same time, the debtor must meet with the Office of the U.S. Trustee (UST), comply with a host of administrative requirements and work on the preparation of a set of bankruptcy schedules that, in even a small case, can be a substantial undertaking.

Shortly after the bankruptcy filing, the UST will usually appoint a creditors’ committee and sometimes other committees to represent the interests of creditors and/or other stakeholders. These committees may consult with the debtor on the administration of the case, investigate the conduct of the debtor and the operation of the business, and participate in the formation of a reorganization plan. In addition, a creditors’ committee may, with the court’s approval, hire an attorney and/or other professionals to assist in the performance of the committee’s duties.

Protracted negotiations with the committees are typical. The early days of the case provide the debtor with an opportunity to educate the committee and its counsel, and to develop a working relationship with the committee. This can be a key to success in chapter 11.

Early negotiations with other major creditors is also typical—particularly with major pre-petition secured lenders. If the debtor requires post-petition financing, it will also spend a lot of time early in the case (and indeed, pre-petition) with its post-petition lenders, which may be the same entities that loaned it money pre-petition, or perhaps be new lenders.

Immediately upon filing, the debtor and everyone that deals with the debtor become subject to the rules of the Bankruptcy Code, which include the following.

The Automatic Stay

The commencement of a bankruptcy case triggers an “automatic stay,” which, with certain exceptions, operates as an injunction against actions affecting the debtor or its property. The automatic stay provides a respite for the debtor and also protects the creditors as a group by bringing to a halt actions by individual creditors to obtain satisfaction of their claims using the remedies available under state law.

The automatic stay usually does not protect parties who are not themselves in bankruptcy, such as guarantors or co-obligors. On occasion, a judge will be willing to extend the automatic stay to a non-debtor, but those instances are rare.

Moreover, the Bankruptcy Code also expressly carves out a number of exceptions to the scope of the automatic stay, which are listed in §362(b) of the Code. A creditor may seek relief from the automatic stay. The standards for obtaining relief are set forth in §362(d) of the Code.

Use, Sale or Lease of Property of the Estate

The debtor may use, sell or lease its property in the ordinary course of its business without authorization from the bankruptcy court. However, the use, sale or disposition of any property outside the ordinary course of business requires court approval. For example, a retail debtor can sell its inventory to retail customers without court approval, but if it wants to sell wholesale stores or enter into major new leases, it will require court approval. There are closer calls, of course, and sometimes a debtor will seek court permission “just to be safe.”

Section 363 of the Bankruptcy Code and interpretive cases govern this inquiry.

New Credit

Some debtors have enough unencumbered cash to enable them to operate in chapter 11 without new cash infusions. Others must rely on cash that is subject to a lender’s security interest, referred to as “cash collateral.” In order to use cash collateral, a debtor must obtain agreement of the secured party or court authorization. If the creditor does not consent to the use of its cash collateral, then the debtor must provide “adequate protection” to the lender—essentially, the debtor must compensate the creditor in some way for the use of its cash collateral. All of this is laid out in a relatively straightforward manner in §363, and (like almost everything we have said, say and will say in our first three installments) will be discussed in more detail in a future installment.

However, many debtors cannot survive even with use of cash collateral. Instead, a debtor may require a line of credit or other post-petition financing. Section 364 of the Bankruptcy Code permits a debtor to borrow funds and offers protections and priorities to induce lenders to make these loans, which are referred to as debtor-in-possession loans or simply “DIP loans.”
These inducements are offered to lenders because, without them, lenders might be unwilling to loan money to a bankrupt company, or at least the cost of borrowing would be much higher. The inducements consist of a steadily increasing series of liens and priorities. The first is ordinary administrative priority. Second is priority over other administrative expenses (so-called superpriority). Third is a lien on unencumbered assets. And finally, if the debtor cannot get financing on any other terms, the court may authorize a lien that is equal to, or even senior to, other liens on estate assets. While intuitively it may seem a risky proposition to lend to a company in bankruptcy, because of the incentives and protections provided by the Bankruptcy Code to DIP lenders, it is often a very safe proposition for DIP lenders, provided that they properly take advantage of the protections offered in §364. And it can be a profitable business, since these loans often come with hefty fees.

**Executory Contracts and Leases**

The Bankruptcy Code contains no precise definition of an “executory contract.” As a general matter, an executory contract is one in which performance remains due to some extent on both sides (for instance, ongoing leases or supply agreements). Section 365 of the Bankruptcy Code provides the debtor with tremendous flexibility regarding these types of ongoing agreements. They can be assumed and performed by the debtor, assigned to a third party (in most cases) or rejected. By assuming (or assigning) a contract, the debtor binds itself (or its assignee) and all other contracting parties to perform the contract fully in accordance with its original terms. Rejection of a contract releases all parties of any further obligations to perform their contractual duties. The decision to assume, assign, or reject a contract requires court approval, but the courts typically defer to the debtor’s business judgment. Until a contract is assumed or rejected, both the debtor and the non-debtor party are generally obligated to perform under it.

As a general rule, but with an important exception for most commercial real estate leases, a debtor is not obligated to make the decision to assume, assign or reject until the confirmation of a plan. A party bound under a contract or lease with a debtor may, however, move for an earlier deadline, if it can show that the delayed decision would prejudice it in some significant way.

For public policy reasons (or as a result of special interests pressure), the Bankruptcy Code contains provisions that deal with certain types of executory contracts, including leases of commercial real estate, shopping center leases, aircraft leases and financing agreements, timeshare contracts, commitments to maintain the capital of a federally insured bank and intellectual property licenses. Although each special provision is different, the general effect of each set of rules is to restrict the debtor’s rights and increase the protections afforded to the non-debtor party to the contract.

**The “Middle” of the Case**

Activity in a chapter 11 case typically slows down a bit after the first few weeks. Business operations tend to normalize, and the debtor is in many ways able to conduct “business as usual.” However, in addition to running its business, the debtor must comply with the various obligations bankruptcy law imposes. It must remain cognizant of deadlines imposed by the Bankruptcy Code and Rules. There will be disclosure obligations, less confidentiality and more public scrutiny than before bankruptcy. Various constituencies will feel free to comment on what the debtor should or should not be doing, and to attempt to second-guess decisions that outside of bankruptcy would be within the sole purview of management. And the debtor will have to obtain court approval for some acts that it previously could undertake in its discretion. So “business as usual” is relative.

Early in the “middle” of the case, the debtor must attend a “first meeting of creditors” (also referred to as a “341 meeting” because of the Code section that requires the meeting to occur). At this meeting, the debtor (through a representative, if it is an entity) must answer questions posed by the UST, and sometimes by creditors, under oath. Other “administrative” obligations of the debtor in the middle of the case include the filing of monthly operating reports and the payment of quarterly fees to the UST. Of course, the debtor must ordinarily comply with its non-bankruptcy obligations as well, such as filing tax returns and SEC filings.

The “middle” of the case also affords the debtor a chance to evaluate its business and legal strategies. The specifics will, of course, vary from case to case, but business strategy evaluation might include things like whether to sell or shut down stores or plants or particular business lines, whether the workforce is of optimal size, ways to reduce expenses and improve profitability, and so forth. Legal strategy will include ways to use the special powers of a debtor to enhance the estate, including assumption and rejection of contracts and actions to avoid and recover pre-petition payments.

Finally, the middle of the case will involve a lot of negotiating with players in the case, including committees, the UST, secured creditors, landlords, labor unions, government agencies, suppliers and others. Some of this negotiation will relate to exit from bankruptcy, but much of it will relate to the various interim issues that arise in every case.

Often interspersed with this negotiation is litigation over various matters, such as creditors who seek relief from the automatic stay, landlords who want the debtor to assume or reject leases, disputes over the extension of various time periods, arguments over whether creditors are receiving adequate protection, and many other issues that can arise.

Through all this, the debtor—with counsel’s assistance—must focus on the ultimate objective of the case and try not to get too distracted by the myriad of issues that arise. This stage of life is, for some debtors, the beginning of the golden years, while for others it is a mid-life crisis.

Next Issue: The Life Cycle Continued.

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