LEXVID
CONTINUING PROFESSIONAL EDUCATION

BUSINESS BANKRUPTCY BASICS

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Macdonald Fernandez LLP is a law firm focusing on commercial bankruptcy, turnaround and insolvency litigation throughout California and *pro hac vice* in Delaware, the Southern District of New York and Nevada. The firm focuses in particular upon small business chapter 11 cases, single asset real estate cases and individuals in business. Mr. Fernandez has been recognized as a Super Lawyers Magazine "Rising Star" every year since 2012.

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INTRODUCTION

Scope

These materials cover the basics of chapter 11 bankruptcy. However, it is important to have a basic understanding of chapter 7 as well as it provides a framework for concepts that apply throughout the bankruptcy code, including in chapter 11. It is also important to understand the background of the Bankruptcy Code and bankruptcy administration.

The Bankruptcy Code

Congress is empowered to enact "uniform Laws on the subject of Bankruptcies" pursuant to Article I, Section 8, of the United States Constitution. Congress enacted the Bankruptcy Code in 1978 (Title 11 of the United States Code), replacing the Bankruptcy Act of 1841. The Bankruptcy Code has been amended several times. The most significant recent amendment is the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). Bankruptcy procedures are governed by the Federal Rules of Bankruptcy Procedure (abbreviated "Fed. R. Bankr. P." and sometimes "FRBP") and by the local rules and guidelines of each bankruptcy court. The Federal Rules of Bankruptcy Procedure include official forms for use in bankruptcy cases.

One of the fundamental goals of the Bankruptcy Code is to give debtors a "fresh start." "[I]t gives to the honest but unfortunate debtor…a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt." *Local Loan Co. v. Hunt*, 292 U.S. 234, 244 (1934). This is primarily done through a discharge of debt, which discharges personal liability – it does not discharge security interests (liens) – and enjoins creditors from taking any action thereon. An individual in chapter 7, and an individual and a business entity in chapter 11, are entitled to a discharge under certain circumstances. A corporation or other business entity cannot receive a discharge in a chapter 7 case; the assets of the entity are simply liquidated or abandoned and the shell entity effectively winds up, whether or not it is formally dissolved thereafter.

Chapter 7

A chapter 7 case is an orderly liquidation in which a trustee takes control of the assets of the debtor, sells them or otherwise disposes of them (e.g., by abandoning valueless or burdensome assets) and makes distributions to creditors, subject to an individual debtor's right to retain certain exempt property (a business entity is not entitled to exemptions) and the rights of secured creditors in their collateral. Where there is little or no non-exempt property (a "no-asset case"), there may not be an actual liquidation. In contrast to the debtor in chapter 11, the extent of many chapter 7 debtors' post-filing involvement in the case is limited to an appearance at the First Meeting of Creditors conducted by the chapter 7 trustee pursuant to Bankruptcy Code Section 341 (often called a "Section 341 Meeting of Creditors"). This meeting, which is also held in chapter 11 cases (but conducted by the United States Trustee) provides an opportunity for the trustee and creditors to examine the debtor concerning the assets, liabilities and financial affairs of the debtor. A general unsecured creditor will receive a distribution in chapter 7 only if the

case is an asset case and the creditor files a proof of claim with the bankruptcy court. In most individual chapter 7 cases, the debtor receives a discharge a few months after the petition is filed.

The BAPCPA now requires the application of a "means test" to determine whether individual consumer debtors qualify for relief under chapter 7 (individual debtors with primarily business debt automatically qualify). If the debtor's income is in excess of certain thresholds, the debtor may not be eligible for chapter 7 relief.

Chapter 11

In a chapter 11 reorganization, the business entity or individual generally continues operating its business with the goal of reorganizing the business and paying creditors (in whole or in part) through a chapter 11 plan of reorganization. For example, the debtor can sell assets free and clear of disputed liens, reject or assume and assign executory contracts and unexpired leases, recover assets (including avoidable transfers) and otherwise adjust its operations to return to profitability.

In a chapter 11 case, the debtor is a "debtor in possession," generally possessing all of the powers of a chapter 7 trustee. The debtor retains all assets and control over the estate (unless a chapter 11 trustee is appointed or other action is taken) and actively administers the estate for the benefit of creditors, equity security holders and other parties in interest, as appropriate. The debtor can also terminate burdensome contracts and leases, recover assets and re-size its operations in order to return to profitability. The debtor has the exclusive right to file a chapter 11 plan in the first 120 days of the case, unless the exclusivity period is terminated early (by motion or by the appointment of a chapter 11 trustee, for example). The debtor must provide creditors with a court-approved disclosure statement with information adequate for creditors to evaluate and vote on the plan. If the vote is favorable, the debtor requests that the bankruptcy court confirm the plan. Confirmation of a plan can enable the debtor to reduce its debts by repaying a portion of its obligations and discharging others and accomplish certain other reorganization goals.

AUTOMATIC STAY

Bankruptcy Code Section 362(a) provides that the filing of a voluntary petition automatically enjoins most actions to collect from the debtor or the debtor's property (including lawsuits, foreclosures, wage garnishments, dunning letters and telephone calls), without notice. This is called the "automatic stay," and it is a unique and powerful injunction. But the automatic stay does not stay certain types of actions (which are generally listed under Bankruptcy Code Section 362(b)) and the stay may be limited in scope and time under some circumstances, including serial filings.

The automatic stay enjoins substantially all actions, collection activities, foreclosures and repossessions of property on account of any claim that arose prior to the date that the case was commenced (called the "petition date"). 11 U.S.C. § 362(a). The stay automatically goes into effect, with or without notice, when the "order for relief" is entered. The filing of a voluntary bankruptcy petition constitutes the order for relief, whereas the order for relief is entered later

(sometimes after a trial) in an involuntary case. 11 U.S.C. §§ 301(b) & 303(h). The filing of a petition, however, does not operate as a stay for certain types of actions listed under Bankruptcy Code Section 362(b), as mentioned above. The stay provides a "breathing spell" for the debtor, during which negotiations can take place and the debtor can stabilize its financial affairs.

A secured creditor may obtain relief from the automatic stay under certain circumstances, which permits the creditor to foreclose or otherwise dispose of its collateral. 11 U.S.C. § 362(d). The most common grounds for relief from the automatic stay are that the debtor has no equity in the property and the property is not necessary for an effective reorganization. Relief from the automatic stay may also be granted for cause, including lack of "adequate protection," which the debtor may provide under Bankruptcy Code Section 361.

DISCHARGE

What is the discharge?

The discharge generally releases the debtor from all personal liability arising pre-petition. The discharge enjoins creditors from taking any action on account of a discharged debt, including lawsuits and contact with the debtor, such as telephone calls, correspondence and personal contact. Bankruptcy Code Section 727 governs discharge in a chapter 7 case, Section 1141 provide for a discharge in certain chapter 11 cases and Section 524 provides for a discharge injunction.

The discharge does not affect security interests (liens), which are generally protected by the Takings Clause of the Fifth Amendment to the United States Constitution. Putting aside the opportunity to avoid certain liens in bankruptcy, assets will remain subject to valid liens notwithstanding the fact that any related personal liabilities have been discharged. Accordingly, assets encumbered by liens remain subject to enforcement of the lien, including by foreclosure or other action to take possession and dispose of the collateral.

When does the discharge occur?

In a chapter 7 case, the discharge is ordinarily entered upon expiration of the deadline for filing a complaint objecting to discharge of certain debts (generally under Bankruptcy Code Section 523) and the deadline for filing a motion to dismiss the case for substantial abuse (including failure under the "means test."). This is 60 days following the date first set for the Section 341 Meeting of Creditors, which usually falls approximately four months after the petition date. Fed. R. Bankr. P. 4004(a). Ordinarily, the discharge is automatically entered unless there is pending litigation involving objections to the discharge. Fed. R. Bankr. P. 4004(c). In individual chapter 11 cases, a discharge is typically entered upon completion of all payments under a confirmed chapter 11 plan. An individual debtor may obtain an "early discharge" prior to completion of plan payments "for cause." 11 U.S.C. § 1141(d)(5)(A); *see, e.g.*, *In re Sheridan*, 391 B.R. 287, 291 (Bankr. E.D.N.C. 2008) (grounds for early discharge established by showing likelihood that all plan payments will be made and there is sufficient equity to liquidate and pay impaired class the same amount promised under the plan if debtor defaults). In practice, an early discharge is rate. The court may deny discharge in an individual chapter 7 or 11 case if the debtor fails to

complete an approved post-petition financial management course and file a certificate of completion. 11 U.S.C. §§ 727(a)(11) & 1141(d)(3); Fed. R. Bankr. P. 4004(c)(1)(H).

Confirmation of a chapter 11 plan discharges the debtor from any claim that arose prior to confirmation. 11 U.S.C. § 1141(d)(1). The plan replaces pre-confirmation obligations, and the debtor is bound by the terms of the plan, including the requirement to make payments to fund distributions to creditors.

However, an individual debtor generally does not receive a discharge until all plan payments have been made. 11 U.S.C. § 1141(d)(5). Moreover, individual debtors are not discharged from any nondischargeable debts listed in Bankruptcy Code Section 523. Also, a discharge is generally not available in a liquidating plan unless the debtor is an individual. 11 U.S.C. § 1141(d). Confirmation of a liquidating plan for an individual will result in a discharge after plan payments the debtor would be denied a discharge under Bankruptcy Code Section 727. 11 U.S.C. § 1141(d)(3). An individual debtor will continue to be liable on account of such claims unless they are paid through the plan.

Scope and denial of discharge

The discharge does not extend to all debts. As discussed above, the discharge does not terminate security interests (liens). Moreover, Bankruptcy Code Section 523 excepts from discharge certain specific debts in individual cases. These generally include certain tax claims, domestic support, debts for willful and malicious injuries, government fines and penalties, student loans, personal injury claims against drunk drivers, obligations to certain tax-advantaged retirement plans and certain condominium or cooperative housing fees. A broader discharge is available in chapter 13, including debts for willful and malicious injury, debts incurred to pay non-dischargeable taxes and debts arising from property settlements in marital dissolution proceedings (but note that a "hardship discharge" in chapter 13 is more limited in scope). Chapter 13 is not discussed here. The foregoing exceptions to discharge apply only to individuals, not business entities in chapter 11 cases.

Most of the exceptions from discharge apply automatically, but some do not. 11 U.S.C. § 523(c). The exceptions provided in Bankruptcy Code Sections 523(a)(2) (fraud), 523(a)(4) (fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny) and 523(a)(6) (willful and malicious injury) are not automatic. Creditors are required to file a complaint and commence an "adversary proceeding," which is a lawsuit in bankruptcy court, in order to take advantage of these exceptions from discharge.

A creditor, the chapter 7 trustee or the United States Trustee may also object to entry of the debtor's discharge in general; if successful, this means that no debts of any kind are discharged. The deadline to object to discharge in chapter 7 is 60 days after the date first set for the Section 341 Meeting of Creditors. By contrast, an objection to discharge in a chapter 11 case may be filed any time before the date first set for confirmation of a chapter 11 plan. Fed. R. Bankr. P. 4004(a). Filing such a complaint commences an adversary proceeding, and the objecting party carries the burden of proof.

Bankruptcy Code Section 727(a) provides a list of grounds for denial of discharge, including failure to keep or produce adequate books and records, destruction or concealment of books or records, failure to complete a post-petition financial management course, transfer or concealment of assets with intent to hinder, delay, or defraud creditors, perjury and other fraudulent acts, commission of a bankruptcy crime such as perjury, failure to account for lost property, violation of a court order and receipt a discharge in another case commenced within certain time frames (serial filing). 11 U.S.C. § 727; Fed. R. Bankr. P. 4005. The grounds are narrow and are construed against the moving party.

The discharge will be denied to an individual in chapter 7 if the debtor previously received a discharge in a chapter 7 or 11 case filed within the prior eight years. 11 U.S.C. § 727(a)(8). The discharge will be denied if the debtor received a discharge in a chapter 12 (for family farmers and fishermen) or 13 case filed within the prior six years unless the debtor paid all allowed unsecured claims in full or made payments under a plan totaling at least 70 percent of the allowed unsecured claims, the debtor's plan was proposed in good faith and the payments represented the debtor's best effort. 11 U.S.C. § 727(a)(9). A chapter 13 discharge is not available if the debtor received a discharge in a chapter 7, 11 or 12 case commenced within the prior four years or in a chapter 13 case commenced within the prior two years. Such limitations do not apply to individuals or business entities in chapter 11 cases. However, neither an individual nor a business entity is entitled to a discharge in a liquidating chapter 11 case. 11 U.S.C. § 1141(d)(3).

Reaffirmation

As discussed above, the discharge does not affect secured claims (liens), and secured creditors may be entitled to take possession of collateral. Under some circumstances, the debtor may move to reaffirm a pre-petition debt, especially when there is a default and an impending post-discharge foreclosure or repossession. Reaffirmation is an agreement that the debtor will remain liable for all or a portion of pre-petition debt. The debt must be reaffirmed before the discharge is entered. A signed, written reaffirmation agreement must be filed with the court along with an extensive set of disclosures, including current income and expenses sufficient to pay the reaffirmed debt. 11 U.S.C. §§ 524(c) & (k). If net income is not sufficient, there is a presumption of undue hardship and the court may decline to approve the reaffirmation. If the debtor has counsel, the attorney must certify that the debtor was advised of the legal consequences of reaffirmation (including the impact of default under the reaffirmation agreement), that the debtor knowingly and voluntarily entered into the agreement and that reaffirmation will not cause undue hardship for the debtor or his or her dependents. 11 U.S.C. § 524(k). A hearing is required if the debtor was not been represented by an attorney in negotiating the agreement or if the court initially declines to approve the reaffirmation. 11 U.S.C. §§ 524(d) & (m).

However, a debtor may voluntarily repay a discharged debt, even though it can no longer be enforced, whether or not the debt has been reaffirmed. 11 U.S.C. § 524(f). This is frequently done on account of debts owed to family members, where a moral obligation or the debtor’s reputation is at stake.

Can the discharge be revoked?

Under certain circumstances, the discharge can be revoked. A creditor, the chapter 7 trustee or the United States Trustee may request revocation of the discharge in a chapter 7 case where the debtor obtained the discharge fraudulently, failed to disclose assets of the bankruptcy estate, refused to obey lawful orders of the court or to testify under certain circumstances (11 U.S.C. § 727(a)(6)), failed to explain misstatements discovered in an audit of the case or failed to provide information requested in the audit. 11 U.S.C. § 727(d)(3). A request to revoke the discharge for fraud must be filed within one year of entry of the discharge; if upon other grounds, the request must be made before the late of one year after entry of the discharge or the date the case is closed. 11 U.S.C. § 727(e). In chapter 11 (and 12 and 13) cases, an order confirming a plan providing for a discharge obtained through fraud can be revoked within 180 days of entry of the order. 11 U.S.C. § 1144.

How does the discharge provide protection?

The discharge is an injunction against all collection action, including lawsuits. 11 U.S.C. § 524. What can a debtor do when a creditor attempts to collect a discharged debt? The debtor can file a motion asking that the case be reopened to address violations of the discharge injunction. The court may assess civil sanctions against the creditor for violating the discharge injunction, often punishable by a fine, under Bankruptcy Code Section 105(a).

Can the debtor's employment be terminated because he or she filed bankruptcy or failed to pay a discharged debt? No. Bankruptcy Code Section 525 prohibits discriminatory treatment by private and public employers.

CHAPTER 7

Chapter 7 of the Bankruptcy Code provides for liquidation, which is the sale of a debtor's nonexempt property and the distribution of the proceeds to creditors. Although this program covers chapter 11 cases, understanding chapter 7 is important as it serves as a foundation and background for many of the concepts applicable throughout the Bankruptcy Code.

Alternatives to chapter 7

There are several alternatives to chapter 7 relief, including chapter 11. A chapter 11 case may be more appropriate for debtors engaged in business (including individuals, corporations and other business entities), who may prefer to continue in business and avoid liquidation. Individuals and sole proprietorships (which are not separate business entities) may be eligible for relief under chapter 13. These materials do not cover chapter 13 cases, nor do they cover chapter 9 cases for municipalities, chapter 12 cases for family farmers and fishermen or chapter 15 cases for foreign proceedings.

Assignments for the benefit of creditors, bulk sales, receiverships (generally not commenced by the debtor), wind-up and dissolution and agreements with creditors out of court may provide alternatives to bankruptcy. Be careful to avoid individuals and organizations promising to

prevent foreclosures or avoid bankruptcy without legitimate grounds; these scams often involve the filing of incomplete bankruptcy petitions (following which there is no appearance by an attorney), the transfer of assets to a third party or trust (which may be in or out of bankruptcy itself) or the placement of fraudulent junior liens against assets.

Background

In a chapter 7 case, the bankruptcy trustee gathers and sells the debtor's nonexempt assets and uses the proceeds to pay creditors' claims in the order of priorities provided in the Bankruptcy Code, including distributing assets to holders of general unsecured claims *pro rata* based on the size of the claim. An individual debtor is entitled to keep certain exempt property; a business entity is not entitled to any exemptions. By contrast to a chapter 11 case (and a chapter 13 case), a chapter 7 bankruptcy case does not involve the filing of a plan of reorganization.

Chapter 7 eligibility

A chapter 7 debtor may be an individual, a partnership, or a corporation or other business entity. 11 U.S.C. §§ 101(41) & 109(b). The court may dismiss the chapter 7 case of an individual with primarily consumer debts if the court finds that the granting of relief would be an abuse of chapter 7. 11 U.S.C. § 707(b). If the debtor's current monthly income (as defined in Bankruptcy Code Section 101(10A)) is more than the state median, the case is presumptively abusive if the aggregate current monthly income multiplied by 60 (this is to project income over 60 months or five years), net of certain prescribed expenses, exceeds the smaller of: (a) the greater of 25% of nonpriority unsecured debt or $7,475; or (b) $12,475. 11 U.S.C. § 707(b)(1)(A)(i). Note that these figures are subject to periodic adjustment. 11 U.S.C. § 104. The debtor may rebut the presumption of abuse only by a showing of special circumstances that justify additional expenses or adjustments of current monthly income. 11 U.S.C. § 707(b)(2)(B)(i). Unless the presumption is rebutted, the case will generally be dismissed or, with the debtor's consent, converted to chapter 13. This calculation is commonly called the "means test." A business entity need not satisfy the means test.

Although an individual debtor with primarily consumer debt must pass the means test, described above, there is no cap on the debtor's level of debt, and there is no requirement that the debtor be insolvent (although a case may be dismissed if it was filed in bad faith). However, an individual is barred from chapter 7 if within the prior 180 days (1) a prior bankruptcy case was dismissed due to the debtor's willful failure to appear before the court or comply with orders of the court or (2) the debtor voluntarily dismissed a case in the face of a motion for relief from the automatic stay. 11 U.S.C. § 109(g). Moreover, an individual debtor must have received credit counseling from an approved agency within the prior 180 days, with certain exceptions for emergencies or lack of access. 11 U.S.C. §§ 109(h). Any debt management plan developed during the credit counseling must be filed with the court, although this is rare. 11 U.S.C. § 512(b); Fed. R. Bankr. P. 1007(b)(3)(A).

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Commencement of case

First, the debtor files a voluntary petition with the bankruptcy court for (1) the area where the individual lives or (2) where the business debtor is (a) organized, (b) has its principal place of business or (c) has its principal assets. An involuntary chapter 7 case may be commenced under certain circumstances by creditors of the debtor. 11 U.S.C. § 303. In addition to the petition, the debtor must also file with the court: schedules of assets and liabilities; a schedule of current income and expenditures; a statement of financial affairs; a schedule of executory contracts and unexpired leases; and certain other initial documents. Fed. R. Bankr. P. 1007(b). Copies of the tax return or transcripts for the most recent tax year as well as tax returns filed while the case is pending (including tax returns for prior years that had not been filed before the petition date) must also be provided to the trustee. 11 U.S.C. § 521. Individual debtors must also file a certificate of credit counseling and a copy of any debt repayment plan developed during the counseling; payment advices from employers (if any) received 60 days before filing; statements of average monthly income and expenses and any anticipated change in income or expenses; and a statement of any interest the debtor has in federal or state qualified education or tuition accounts. *Id.* Spouses may file a joint petition or individual petitions. 11 U.S.C. § 302(a). Although filing jointly, spouses are still subject to all the document filing requirements of individual debtors.

In order to complete the petition, schedules and statement of financial affairs, the debtor must disclose:

1. All creditors, their contact information and the amount and nature of their claims;
2. The source, amount, and frequency of the debtor's income;
3. All of the debtor's property; and
4. The debtor's monthly income and expenses.

Spouses must gather this information (including actual income and expenses) with respect to each spouse regardless of whether they are filing jointly, separately or if only one spouse is filing. One of the schedules is a list of exempt property. Pursuant to Bankruptcy Code Section 522(b), an individual debtor may exempt property if it is exempt under federal bankruptcy law or under state law.

Section 341 Meeting of Creditors

The Section 341 Meeting of Creditors will be set between 21 and 40 days after the petition is filed in a chapter 7 or chapter 11 case (21 to 35 days in chapter 12, 21 to 50 days in chapter 13 and up to 60 days in all cases if held at a place not regularly staffed by the United States Trustee). Fed. R. Bankr. P. 2003(a). The trustee does, and creditors may, question the debtor regarding assets, liabilities and financial affairs under oath during the meeting. 11 U.S.C. § 343. If spouses file a joint petition, both must attend. The United States Trustee will report to the court whether the case should be presumed to be abusive under the means test provided in Bankruptcy Code Section 704 within 10 days of the creditors' meeting. 11 U.S.C. § 704(b)(1). Bankruptcy judges are prohibited from attending the meeting of creditors. 11 U.S.C. § 341(c).

Exemptions

States are permitted to opt-out of the Bankruptcy Code's exemptions and instead apply their own state-law exemptions. California has opted out but created its own separate set of exemptions that parallel the Bankruptcy Code's exemptions. This allows California debtors to choose between two sets of exemptions, which are: (1) California Code of Civil Procedure ("Cal. Code Civ. Proc.") Section 704.010 *et seq.* (traditional state-law exemptions, sometimes called "System 1"); and (2) Cal. Code Civ. Proc. § 703.140 *et seq.* (bankruptcy-style exemptions, sometimes called "System 2").

These materials do not cover exemptions, although it is important to note that they do play a role in chapter 11 cases for individuals, at least in that creditors objecting to confirmation of a chapter 11 plan must receive at least as much as they would receive in a chapter 7 cases (this is called the "best interests of creditors test"). 11 U.S.C. § 1129(a)(7)(A). The debtor's exemptions reduce this amount because creditors do not receive the proceeds of exempt assets in a chapter 7 case.

Role of the chapter 7 trustee

The commencement of a bankruptcy case creates an estate, which succeeds to all of the debtor's property. The estate consists of all legal or equitable interests of the debtor, including property owned or held by another person if the debtor holds an interest therein. The chapter 7 trustee is the representative of the estate. In California and most other states, the United States Trustee appoints a chapter 7 trustee to liquidate nonexempt assets and administer the case. 11 U.S.C. §§ 701 & 704.

The chapter 7 trustee generally liquidates the nonexempt assets of the estate and maximizes the distribution unsecured creditors. Specifically, the trustee sells assets that are free liens or worth more than the liens plus any applicable exemption. If the debtor is a business, the trustee may operate the business for a limited time, subject to court approval. 11 U.S.C. § 721.

Claims

The trustee will typically report that the case is a no-asset case if all the debtor's assets are exempt or overencumbered, in which case there will be no distribution to unsecured creditors. In a no-asset case, proofs of claim need not be filed.

If assets are later discovered, creditors will receive notice and an opportunity to file proofs of claim. If the case appears to be an asset case, unsecured creditors must file claims with the court in order to receive a distribution. Proofs of claim must be filed within 90 days after the date first set for the Section 341 Meeting of Creditors. Fed. R. Bankr. P. 3002(c). However, government claims can be filed up to 180 days from the petition date. 11 U.S.C. § 502(b)(9).

Although a secured creditor need not file a proof of claim to preserve its security interest (lien), there may be good reasons to file a claim. For example, the debtor may have disputed the amount of the claim secured by the lien.

Avoidable transfers

The trustee is entitled to recover money or property under the trustee's avoiding powers (also called the trustee's "strong-arm powers"). In particular, the trustee may sue to avoid (that is, to reverse or set aside) transfers made to creditors within 90 days before the petition (or one year if to insiders of the debtor) when the debtor was insolvent, under certain circumstances. 11 U.S.C. § 547. Such transfers are called "preferences." The Trustee may also avoid security interests and prepetition transfers that were not perfected under applicable non-bankruptcy law. 11 U.S.C. § 544. Moreover, the Trustee can avoid fraudulent transfers under both bankruptcy and non-bankruptcy law. 11 U.S.C. §§ 544 & 548.

Conversion or dismissal

The debtor must generally cooperate with the trustee and provide any financial records requested. If not, and for other cause and under certain other circumstances as well, the trustee or another party in interest may request that the case be converted to another chapter of the Bankruptcy Code or dismissed. A chapter 7 case may only be converted to chapter 11, unless the debtor consents to conversion to chapter 12 or 13. The debtor may also voluntarily convert the case if it has not previously been converted from another chapter (the debtor may not repeatedly convert the case). In all cases, the debtor must be eligible to be a debtor in the target chapter of the Bankruptcy Code. 11 U.S.C. § 706(a).

Distribution

Assets of the estate, or their proceeds, are distributed in accordance with the order of priorities provided in Bankruptcy Code Section 726. Claims fall into six classes, and each class must be paid in full before the next lower class is paid. The debtor is entitled to be paid only if all unsecured creditors have been paid in full.

CHAPTER 11

Chapter 11 of the Bankruptcy Code generally provides for reorganization, usually involving a corporation, partnership or other business entity but including individuals as well.

Note on individuals in chapter 11

An individual cannot be a debtor in chapter 11 (or any other chapter of the Bankruptcy Code) if, during the preceding 180 days, a case was dismissed for willful failure to appear or comply with court orders or was voluntarily dismissed in the face of a pending motion for relief from the automatic stay. 11 U.S.C. § 109(g). Moreover, an individual does not qualify unless he or she received credit counseling from an approved agency within the prior 180 days. 11 U.S.C. §§ 109 & 111. There are exceptions for emergency situations and certain other circumstances. Any debt management plan developed during the credit counseling must be filed with the court, although this is rare. 11 U.S.C. § 512(b); Fed. R. Bankr. P. 1007(b)(3)(A). It is also important to note that the application of the absolute priority rule to individual debtors in chapter 11 is a controversial matter, as discussed below.

How does chapter 11 work?

Chapter 11 is most often used to reorganize a business operated by an individual or a business entity. Corporations and other business entities exist separate and apart from their owners (typically shareholders, partners or members). It is important to understand that a sole proprietorship is not an independent business entity and cannot be reorganized separately from the individual owner. A separate business entity's chapter 11 case does not put at risk the personal assets of the owners other than the value of their investment (the value of their stock), although it may trigger personal guarantees. There is an exception: Although a partnership is independent from its owners, in a partnership chapter 11 case, the partners' assets may be used to pay creditors in some cases.

A chapter 11 case is typically commenced by filing a voluntary petition with the bankruptcy court. An involuntary petition may also be filed by creditors under certain circumstances. 11 U.S.C. §§ 301 & 303. The debtor must also file schedules of assets and liabilities, a schedule of current income and expenditures, a schedule of executory contracts and unexpired leases and a statement of financial affairs. Fed. R. Bankr. P. 1007(b). Individual debtors must file additional documents, including a certificate of credit counseling (and a copy of any debt repayment plan if prepared during counseling), copies of payment advices received within the prior 60 days, a statement of monthly net income and any anticipated change in income or expenses and a statement of any interest the debtor has in federal or state qualified education or tuition accounts. 11 U.S.C. § 521.

Generally, the debtor in possession will file a disclosure statement and plan of reorganization. 11 U.S.C. §§ 1121 & 1125. The disclosure statement must provide information sufficient for a creditor to make an informed judgment and vote upon the plan. 11 U.S.C. § 1125. The type and scope of information necessary varies according to the complexity and size of the case. In a small business case, the debtor may avoid filing a separate disclosure statement if the court determines that the plan provides adequate information. 11 U.S.C. § 1125(f).

The plan must classify claims and specify how each class of claims will be treated. 11 U.S.C. § 1123. The disclosure statement must be approved before creditors vote on the plan, and the debtor is generally prohibited from soliciting votes until the disclosure statement is approved. Creditors whose claims are impaired, meaning those whose rights will be modified or who will not be paid in full, are generally entitled to vote on the plan. 11 U.S.C. § 1126. After the disclosure statement is approved and the ballots are tabulated, a hearing on confirmation of the plan is held. 11 U.S.C. § 1128.

Individual chapter 11 cases have some similarities to chapter 13 cases. In particular, property of the estate includes earnings and property acquired post-petition. Moreover, the plan cannot be confirmed over a creditor's objection without committing all of the debtor's disposable income over five years or the plan payment period, whichever is longer, unless the plan pays the claim in full with interest. 11 U.S.C. §§ 1115, 1123(a)(8), 1129(a)(15).

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The chapter 11 debtor in possession

Upon the commencement of a voluntary case, and upon entry of an order for relief in an involuntary case, the debtor becomes a "debtor in possession" and remains in possession of assets of the estate until and unless a chapter 11 trustee is appointed or the case is converted to another chapter of the Bankruptcy Code. 11 U.S.C. § 1101. A debtor in possession generally has the same powers and duties as a trustee (11 U.S.C. § 1107(a)), and the Bankruptcy Code's use of the term "trustee" is generally interpreted to include a debtor in possession in the context of chapter 11.

The debtor in possession has fiduciary duties to the estate. The debtor in possession has all of the rights and powers of a trustee and is required to perform of all but the investigative duties of a trustee. 11 U.S.C. § 1107. These duties include accounting for property, reviwing and objecting to claims and filing informational reports as required by the court and the United States Trustee (most commonly, monthly operating reports). 11 U.S.C. §§ 1106 & 1107; Fed. R. Bankr. P. 2015(a). The debtor in possession needs court approval to employ attorneys, accountants, appraisers, auctioneers and other professionals. The United States Trustee monitors compliance with reporting requirements.

Railroads in chapter 11 are subject to special requirements, not discussed in these materials. Moreover, stock and commodity brokers are prohibited from filing chapter 11 cases and must file chapter 7 cases instead. 11 U.S.C. § 109(d).

The United States Trustee

The United States Trustee is part of the United States Department of Justice. Although the United States Trustee performs certain tasks that are similar to a chapter 7 trustee (such as conducting the Section 341 Meeting of Creditors in a chapter 11 case), he or she is not a liquidator and does not take control of assets.

The United States Trustee monitors chapter 11 cases and performs certain administration functions. In particular, the United States Trustee reviews monthly operating reports. Moreover, the United States Trustee reviews and may object to applications to employ professionals, including the debtor's counsel, and applications for approval of compensation and reimbursement of expenses of professionals. The United States Trustee may also appear on and oppose disclosure statements, chapter 11 plans and other motions. Creditors' committees are appointed by the United States Trustee.

The United States Trustee conducts the Section 341 Meeting of Creditors as would a chapter 7 trustee. The United States Trustee and creditors are entitled to question the debtor under oath regarding assets, liabilities and financial affairs.

The United States Trustee requires the debtor to establish new bank accounts, known as debtor-in-possession accounts. Banks approved for the management of such accounts must post additional collateral. The court may excuse the requirement of opening new accounts under some circumstances.

The debtor must pay quarterly fees to the United States Trustee until a final decree is entered (following confirmation of a chapter 11 plan), the case is converted or the case is dismissed. 28 U.S.C. § 1930(a)(6). The amount of the fee depends upon the debtor's disbursements during each quarter. If the debtor fails to pay such fees or comply with other reporting requirements, the United States Trustee may – and usually does – file a motion to convert the case to chapter 7 or to dismiss the case.

In North Carolina and Alabama, bankruptcy administrators perform similar functions to the United States Trustees. This distinction is not explored here.

Creditors' committees

Creditors' committees are often appointed in large bankruptcy cases; they are rarely appointed in small cases. The committee's members are usually unsecured creditors who hold the largest unsecured claims against the debtor, although committee members with smaller claims are sometimes appointed for the sake of diversity. 11 U.S.C. § 1102. The committee has significant power, including the right to appear and be heard on virtually every aspect of the administration of the case. In particular, the committee consults with the debtor in possession on administration of the case, investigates the debtor's conduct and operation of the business and participates in formation of a chapter 11 plan. 11 U.S.C. § 1103. A creditors' committee usually retains counsel and may hire other professionals, subject to bankruptcy court approval.

Appointment of a chapter 11 trustee

The United States Trustee, a creditor or a party in interest may move for the appointment of a chapter 11 trustee or examiner any time prior to confirmation of a plan, although the appointment of a trustee is rare. The court must order the appointment of a trustee for cause, including fraud, dishonesty, incompetence, or gross mismanagement, or if a trustee is in the interest of creditors, equity security holders "and other interests of the estate…." 11 U.S.C. § 1104(a). Moreover, the United States Trustee is compelled to request the appointment of a trustee if there are reasonable grounds to believe that anyone in control of the debtor participated in actual fraud, dishonesty or criminal conduct in the management of the debtor or the debtor's financial reporting. 11 U.S.C. § 1104(e). The United States Trustee appoints the chapter 11 trustee, subject to the court's approval, after consultation with parties in interest. Fed. R. Bankr. P. 2007.1. However, a trustee election may be requested within 30 days after the court orders the appointment of a trustee, in which case the United States Trustee convenes a meeting of creditors for the purpose of electing a trustee. 11 U.S.C. § 1104(b).

The chapter 11 trustee is responsible for administering assets of the estate and operating the debtor's business, although usually done in close coordination and with the help of the debtor. The appointment of a trustee terminates the exclusivity period, and the trustee is entitled to file a proposed chapter 11 plan of reorganization. In fact, under Bankruptcy Code Section 1106, the trustee must file a plan as soon as practicable or file a report (1) explaining why a plan will not be filed or (2) recommending that the case be dismissed or converted to another chapter. 11 U.S.C. § 1106(a)(5). Upon request of the United States Trustee, a creditor or a party in interest,

the court may restore the debtor in possession and terminate the trustee's appointment any time before confirmation of a chapter 11 plan. 11 U.S.C. § 1105.

Appointment of an examiner

In the alternative, a bankruptcy court may order the appointment of an examiner, whose role is more limited than a trustee. The examiner performs the investigatory functions of a trustee and is required to file a report of the investigation. If ordered to do so, an examiner may perform other duties of a trustee that the court also orders the debtor in possession not to carry out. 11 U.S.C. § 1106. In some cases, the examiner may file a proposed chapter 11 plan, negotiate or facilitate negotiations, or review the schedules and investigate assets. The examiner may be instructed to determine if any proofs of claim are objectionable or whether claims against third parties are meritorious. The examiner may not subsequently serve as trustee. 11 U.S.C. § 321.

Compensation of professionals

The debtor in possession or trustee may employ professionals only with advance approval of the court. Thereafter, professionals may be paid at the conclusion of the case or during the case, also with advance court approval. The professional applies to the court at intervals of no less than 120 days for interim approval of compensation and reimbursement of expenses. In very large cases, the court may permit more frequent applications under a so-called "Knudsen order." *In re Knudsen Corp.*, 84 B.R. 668, 671-672 (9th Cir. BAP 1998). It is important to note that the debtor cannot make payments to professional creditors on account of prepetition obligations.

Small business cases

A small business case is a case in which the debtor meets two criteria: (1) the debtor is engaged in business, other than primarily owning or operating real property, with total non-contingent, liquidated, secured and unsecured debts of $2,490,925 or less; and (2) the United States Trustee has not appointed a creditors' committee or the bankruptcy court has determined the committee is not sufficiently active and representative to provide oversight. 11 U.S.C. § 101(51D). Note that these amounts are subject to change and that an individual may be a small business debtor.

In a small business case, the debtor must attach to the petition its most recent balance sheet, statement of operations, cash-flow statement and most recently filed tax return or provide a statement under oath explaining their absence. The debtor must also file reports concerning its profitability and projected cash receipts and disbursements and must report whether it complies with the Bankruptcy Code and the Federal Rules of Bankruptcy Procedure and whether it has paid its taxes and filed its tax returns. 11 U.S.C. §§ 308, 1116.

A small business case is intended to proceed more quickly than other cases by reason of certain restrictive deadlines. Specifically, only the debtor may file a plan during the first 180 days of a small business case. 11 U.S.C. § 1121(e). The exclusivity period in an ordinary case is 120 days, but it may be extended for cause up to 18 months after the petition date. 11 U.S.C. § 1121(d)(2)(A). In a small business case, the exclusivity period may be extended only up to 300 days, and only upon a showing that a plan will be confirmed within a reasonable time. A small

business debtor may take advantage of a procedure for combining the plan and disclosure statement, discussed below.

Single asset real estate cases

The Bankruptcy Code imposes special restrictions upon single asset real estate debtors. Single asset real estate is defined as:

> a single property or project, other than residential real property with fewer than four residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the business of operating the real property and activities incidental thereto.

11 U.S.C. § 101(51B). Creditors of a single asset real estate debtor may obtain relief from the automatic stay under circumstances in which such relief is not available to creditors in ordinary bankruptcy cases. Specifically, upon a secured creditor's request and after notice and a hearing, the court will grant relief from stay unless the debtor (1) files a plan of reorganization that has a "reasonable possibility of being confirmed within a reasonable time" or (2) begins making interest payments within 90 days after the petition date (or within 30 days of a determination that the debtor is a single asset real estate debtor) at the non-default contract rate, based upon the value of the lien. 11 U.S.C. § 362(d)(3).

Cash collateral, adequate protection and use of assets

Prior to confirmation of a chapter 11 plan, the debtor may generally use, sell, or lease property of the estate in the ordinary course of business without prior approval. The debtor may request court approval to use assets outside of the ordinary course of business. 11 U.S.C. § 363.

However, a debtor may not use "cash collateral" – in or outside the ordinary course of business – without a court order or the consent of the lienholder. 11 U.S.C. § 363. Cash collateral is cash and any negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents "in which the estate and an entity other than the estate have an interest…." Cash collateral includes the proceeds, products, offspring, rents, or profits of collateral and the fees, charges, accounts or payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties that are subject to a creditor's security interest.

Cash collateral receives special, enhanced protection in bankruptcy on account of its particularly high value to creditors and its liquidity. Accordingly, the debtor must file a motion requesting authority to use cash collateral (a type of "first-day" motion). Until the court approves the proposed use of cash collateral or the lienholder consents (and consent cannot be implied from silence), the debtor must segregate and account for all cash collateral. 11 U.S.C. § 363(c)(4).

A proposed use of cash collateral may be approved on an emergency basis if "necessary to avoid immediate and irreparable harm to the estate pending a final hearing." Fed. R. Bankr. P. 4001(b)(2). For example, the value of an apartment building will drop, and the estate may be

subject to claims by tenants, if the insurance premiums, utility bills, security and maintenance expenses are not paid.

Many of such expenditures also serve the secured creditor's interest in preserving the value of the collateral. Secured creditors may also be entitled to demand adequate protection as a condition of a proposed use of cash collateral in order to protect the value of the creditor's collateral against diminution in value. The debtor may provide adequate protection by providing additional or replacement liens or by making periodic or lump sum cash payments. 11 U.S.C. § 361; *United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 370 (1988) (secured creditor is protected only from post-petition diminution in the value of collateral). Courts will generally require the debtor to provide for disputed interests in cash collateral until the court can address the dispute. *In re Greenhaven Village Apartments of Burnsville Phase II Ltd. Partnership*, 100 B.R. 465, 471 (Bankr. D.Minn. 1989).

Debtor in possession financing

The debtor may be able to obtain cash by obtaining a new loan. This is called debtor-possession financing or DIP financing. Conventional financing is typically not available to a debtor in possession, and the most common sources of DIP financing are the debtor's existing major creditors (who may have a significant stake in a successful reorganization), the debtor's equity security holders and hard money lenders. New debt must be approved by the court under Bankruptcy Code Section 364. The court may grant the new creditor enhanced protection, including "superpriority" status ahead of other general unsecured creditors and a new lien on real or personal property. The court has the power to "prime" existing liens, meaning that the new loan is secured by a lien senior to existing liens, but this is rare.

Matters affecting the use of cash collateral, the use of assets and DIP financing are often subject to significant local rules and guidelines. Special care should be given to properly bring these matters before the court.

Payment of expenses

The debtor in possession pays post-petition expenses in its ordinary course of business, and the debtor may obtain authority to make expenditures and use assets outside the ordinary course of business under Bankruptcy Code Section 363. However, the debtor cannot pay debts that arose pre-petition except under a confirmed chapter 11 plan. This includes ordinary vendors and trade creditors with unpaid invoices and invoices that overlap with the petition date, which must be pro-rated.

By contrast with certain other circuits, co-called "critical vendor" motions – motions to pay certain vendors whose ongoing business is critical to the success of the debtor – are not permitted in the Ninth Circuit. However, courts will generally allow a viable debtor in possession to bring a motion early in the case (one of the common first-day motions) requesting authority to pay certain priority claims early. These typically include wages and benefits within the priority amount (currently $12,475.00) and time period (accrued within 180 days prior to the petition date) provided in Bankruptcy Code Section 507(a)(4), and it may include sales and use taxes

under Section 507(a)(8). Also, in 2005 Congress created Bankruptcy Code Section 503(b)(9), which confers administrative expense priority upon claims for goods delivered to the debtor in the ordinary course of business within 20 days prior to the petition date. Authority to pay for such goods may also be obtained through an appropriate first-day motion, and care should be taken in crafting an appropriate method for determining the amount of such claims as the Bankruptcy Code does not provide for a claims bar date or proof-of-claim procedure for such claims. These early payments are generally approved because a debtor in possession with a viable exit strategy will eventually pay them ahead of other creditors in a chapter 11 plan, and the early payment does not upset the Bankruptcy Code's order of priority.

Sales

As discussed above, the debtor may sell assets in the ordinary course of business without a court order but must obtain court approval to sell assets outside the ordinary course of business. Sales can be done under a confirmed chapter 11 plan or prior to confirmation pursuant to Bankruptcy Code Section 363. Pursuant to Section 363(f), assets can be sold free and clear of liens, claims, interests and encumbrances under certain circumstances. Assets can also be sold free and clear of a co-owner's interest, under certain circumstances, pursuant to Section 363(h). Depending upon the circumstances, the sale may be conducted as a private sale or as an auction (with or without a pre-identified "stalking horse" bidder), often conducted in bankruptcy court. Fed. R. Bankr. P. 6004(f).

Avoidable transfers

The debtor in possession and the trustee have the power to "avoid" or reverse certain transactions for the benefit of the estate. Among other powers, the estate may avoid "preferences," which generally are transfers made to creditors outside the ordinary course of business when the debtor was insolvent and that allowed the creditor to receive more than it would in a liquidation within 90 days prior to the petition date or one year if the creditor is an insider of the debtor. 11 U.S.C. § 547. A typical preference occurs when the debtor pays one vendor faster than others in order to secure that vendor's continuing business post-petition (although the debtor's intent is irrelevant). There are several defenses to a preference claim.

The estate may also avoid both actual and constructive fraudulent transfers (both transfers and new obligations taken on by the debtor can be avoided). 11 U.S.C. § 548. An actual fraudulent transfer requires proof of actual fraudulent intent, whereas a constructive fraudulent transfer is generally a transfer for less than reasonably equivalent value when the debtor was insolvent. Bankruptcy Code Section 548 is subject to a two-year statute of limitations, which runs back from the petition date, but the estate can take advantage of longer state-law limitations periods by proceeding under Bankruptcy Code Section 544, which generally gives the estate the status of a hypothetical creditor. California's limitations period is generally four years. See Cal. Civ. Code §§ 3439.01 *et seq.*

Bankruptcy Code Section 544(a)(3) also gives the estate the status of a *bona fide* purchaser of real property for value without knowledge, which allows the estate to avoid unperfected liens. Other subsections of Section 544 may enable the estate to avoid unperfected liens against

personal property depending upon the type of asset and the applicable recording statute. These are the chief avoiding powers, but this description is not exhaustive.

Motions

Most chapter 11 cases involve matters resolved by motion prior to confirmation of a chapter 11 plan, including motions for relief from the automatic stay, use of cash collateral and approval of post-petition loans. Motions are generally governed by Rules 9013 and 9014 of the Federal Rules of Bankruptcy Procedure. The debtor may also reject or assume and assign executory contracts and unexpired leases. 11 U.S.C. § 365. Indications of bad faith in filing the case, fraud or delays in moving toward confirmation of a plan may prompt creditors or the United States Attorney to file a motion to dismiss the case, convert it to chapter 7 or appoint a chapter 11 trustee. Many courts permit certain motions that are often uncontested to be granted without a hearing, on a negative-notice or "scream or die" basis, pursuant to local rules.

Adversary proceedings

A lawsuit may be brought in bankruptcy court, and it is called an adversary proceeding. For example, the debtor or trustee may sue third parties to avoid liens, preferences, fraudulent transfers or post-petition transfers. The bankruptcy court may also authorize a creditors' committee to pursue actions against insiders of the debtor to avoid conflicts. Creditors and other parties in interest may also initiate adversary proceedings.

Claims

The Bankruptcy Code defines a claim broadly as a right to payment, or a right to an equitable remedy for breach of performance if the breach gives rise to a right to payment, "whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured." 11 U.S.C. § 101(5). In a chapter 11 case, the filing of a proof of claim is not necessary if the creditor's claim is properly scheduled and not marked disputed, contingent or unliquidated. 11 U.S.C. § 1111. However, any unsecured creditor whose claim is not scheduled, is scheduled incorrectly or is scheduled as disputed, contingent or unliquidated must file a proof of claim and attach evidence documenting the claim. Otherwise, the creditor may not be treated as a creditor for the purposes of voting on the plan and receiving distributions. Fed. R. Bankr. P. 3003. The proof of claim supersedes the scheduled claim and will be deemed allowed unless the debtor or another party in interest objects to the proof of claim. A claim objection initiates a contested matter in which the court will determine the validity and amount of the claim.

Equity security holders

An equity security holder is a shareholder, member, limited or general partner and other similar owner. 11 U.S.C. § 101(16), (17). An equity security holder may file a proof of interest (rather than a proof of claim) if the equity security interest is in dispute. Most of the provisions that apply to proofs of claim discussed above are applicable to proofs of interest.

An impaired class of equity security holders is generally entitled to vote on the chapter 11 plan. However, the votes of insiders are not counted for the purposes of confirming the plan over the objection of another impaired class of creditors pursuant to Bankruptcy Code Section 1129(b) (called "cramdown"). Moreover, the plan often proposed to eliminate equity security interests (in which case the class is deemed to reject the plan) or allow holders to retain their equity security interests without modification (in which case the class is unimpaired and does not vote).

Conversion to chapter 7 or dismissal

The debtor can convert the case to chapter 7 once as a matter of right, unless: (1) the debtor is not a debtor in possession (i.e. a chapter 11 trustee has been appointed); (2) the case was originally commenced as an involuntary case; or (3) the case was converted to a case under chapter 11 not at the debtor's request. 11 U.S.C. § 1112(a).

There is no absolute right to dismiss the case. The debtor or a party in interest may bring a motion to dismiss the case or convert to chapter 7 for cause. If cause is found, the court generally must convert or dismiss the case, whichever is in the best interests of creditors and the estate, unless it specifically finds that doing so is not in the best interest of creditors and the estate. 11 U.S.C. § 1112(b). As an alternative remedy, the court may instead appoint a chapter 11 trustee or examiner if it is in the best interests of creditors and the estate. 11 U.S.C. § 1104(a)(3). Bankruptcy Code Section 1112(b)(4) provides examples of cause, including substantial or continuing loss, gross mismanagement, failure to maintain insurance and unauthorized use of cash collateral. Note, however, that Bankruptcy Code Section 1112(c) prevents the court from converting a case involving a farmer or charitable institution to a liquidation case under chapter 7 unless the debtor requests the conversion.

Chapter 11 plan

A confirmed chapter 11 plan modifies the rights of creditors and serves as a new contract between creditors and the debtor. The mandatory provisions of a chapter 11 plan are listed in Bankruptcy Code Section 1123(a), and the optional elements of a plan are listed in Section 1123(b). In general, the plan must classify claims and provide for their treatment. Common classes include holders of security interests, general unsecured creditors and equity security holders.

Liquidation may be proposed in a chapter 11 plan. A liquidating plan allows the debtor to liquidate the business in an orderly fashion under more advantageous circumstances than in a chapter 7 case. Creditors may also take a more active role in the liquidation and the distribution of the proceeds.

More than one plan may be circulated to the creditors for a vote; hence, every proposed plan and modification must be dated and specify the name of the proponent. Fed. R. Bankr. P. 3016(b). When two confirmable competing plans are presented, the court takes into account the preferences of creditors and equity security holders in deciding which to confirm.

The absolute priority rule

The absolute priority rule comes into play if not all classes of impaired claims vote in favor of the plan under Bankruptcy Code Section 1129(a). Nevertheless, the debtor may confirm the plan if certain requirements are met under Bankruptcy Code Section 1129(b). One of these requirements is that each class of unsecured claims will either be paid in full or else junior classes of claims or interests may not receive a distribution. 11 U.S.C. § 1129(b)(2)(B)(ii). The words "absolute priority" do not appear in the statute, and it is subject to several judicially-created exceptions.

There is controversy over whether the absolute priority rule applies in individual chapter 11 cases as it does in business chapter 11 cases; it does not apply in chapter 13 cases. The Bankruptcy Appellate Panel ("BAP") for the United States Courts of Appeal for the Ninth Circuit has held that the absolute priority rule does not apply in individual chapter 11 cases. *In re Friedman*, 466 B.R. 471, 473 (9th Cir. BAP 2012). An Arizona bankruptcy court recently followed *Friedman*, noting that:

> Although there are no Ninth Circuit decisions mandating decisions of the BAP bind bankruptcy courts, this Court agrees with the rationale of Bankruptcy Judge Jaroslovsky from the Northern District of California when he held that a bankruptcy judge's ego should not get in the way of that judge following BAP decisions with which he or she may disagree. *See In re Muskin, Inc.*, 151 B.R. 252 (Bankr. N.D.Ca. 1993). Judge Jaroslovsky pointed out that, among other things, opinions from the BAP are useful tools available to lawyers in plotting strategy for their client's cases and enabling lawyers to settle their bankruptcy issues.

In re Sample, No. 2:10-38373-DPC (Bankr. D. Ariz. July 15, 2013). However, the Ninth Circuit has not ruled upon whether BAP decisions are binding on bankruptcy courts, and some courts apply the absolute priority rule in individual chapter 11 cases.

Who can file a plan?

The debtor (except for a small business debtor) has the exclusive right to propose a chapter 11 plan for 120 days after the petition date. 11 U.S.C. § 1121(b). This "exclusivity period" may be extended or reduced by the court, but in no event may the sum of all extensions exceed 18 months. 11 U.S.C. § 1121(d). After the exclusivity period terminates, the committee, the trustee, a creditor, an equity security holder or another party in interest may file a plan, which may be the only plan proposed or it may compete with the debtor's plan. The debtor may file a plan jointly with a third party. The United States Trustee cannot file a plan. 11 U.S.C. § 307.

The disclosure statement

Ordinarily, a written disclosure statement must be approved by the court before creditors vote on the chapter 11 plan. The disclosure statement must provide "adequate information" concerning the debtor's financial affairs to enable a creditor or equity security holder to make an informed judgment about the plan. 11 U.S.C. § 1125. In a small business case, the court may determine

that the plan itself contains adequate information and that a separate disclosure statement is unnecessary. 11 U.S.C. § 1125(f). Practically speaking, this involves the filing of a combined plan and disclosure statement and approval of the disclosures on short notice, often *ex parte*. The disclosures are tentatively approved subject to final approval at the plan confirmation hearing. Courts have the power to combine the hearing on confirmation and approval of the disclosure statement in other types of cases when appropriate. 11 U.S.C. § 105(d)(2)(B)(vi).

The bankruptcy court holds a hearing on approval of the disclosure statement. Ordinarily, votes on the plan cannot be solicited before approval of the disclosure statement. 11 U.S.C. § 1125(b). However, in a prepackaged bankruptcy plan (or "prepack"), in which the debtor formulates and negotiates a plan before filing for bankruptcy, votes may be obtained before filing. Continued post-petition solicitation is also permissible. Following approval of the disclosure statement, the debtor or other plan proponent may solicit acceptances of the plan, and opponents may solicit rejections.

Voting on the chapter 11 plan

The debtor has 180 days after the entry of the order for relief to obtain acceptances of the plan. 11 U.S.C. § 1121(c)(3). The court may extend this period up to 20 months or reduce it for cause. 11 U.S.C. § 1121(d). An extension of the time for voting is usually sought simultaneously with an extension of the exclusivity period for filing a plan.

Only impaired classes of claims and interests are entitled to vote on the plan. Generally, an impaired claim is one that is not going to be paid completely, will be paid over time or another legal, equitable or contractual right is altered. A class of claims accepts the plan if creditors holding at least two-thirds in amount and more than one-half in number of the allowed claims in that class vote in favor of the plan. 11 U.S.C. § 1126(c). A class of interests has accepted the plan if at least two-thirds in amount vote in favor of the plan, and there is no numerosity requirement. 11 U.S.C. § 1126(d).

If there are any impaired classes of claims, the plan must be accepted by at least one impaired class of claims without counting insiders. 11 U.S.C. § 1129(a)(10). Unimpaired claims are deemed to have accepted the plan, and creditors who will receive or retain nothing under the plan are deemed to reject the plan. 11 U.S.C. §§ 1126(f) & (g).

Plan modification

A plan may be modified at any time before confirmation, but the plan as modified must meet all the requirements of chapter 11 of the Bankruptcy Code. 11 U.S.C. § 1127(a). If after voting, the court must finds that the proposed modification does not adversely affect the treatment of any creditor who has not accepted the modification in writing or else the plan will need to be re-voted. Fed. R. Bankr. P. 3019.

After confirmation but before substantial consummation (generally meaning that plan payments have commenced), the proponent may modify the plan if the modified plan generally meets Bankruptcy Code requirements. 11 U.S.C. § 1127(b). However, a post-confirmation modified

plan only becomes the governing plan if circumstances warrant the modification and the court confirms the modified plan. In an individual chapter 11 case, the debtor, a trustee, the United States Trustee or an unsecured creditor may request a modification to make adjustments to plan payments whether or not the plan has been substantially consummated. 11 U.S.C. § 1127(e).

Plan confirmation

The bankruptcy court will hold a hearing on confirmation of a plan. If contested, the confirmation hearing may proceed as an evidentiary trial. An objection to confirmation of a plan may be filed by any party in interest. The court must determine that the plan complies with all the requirement of Bankruptcy Code Section 1129, whether or not there are any objections. Among other things, the court must find that the plan is feasible, the plan was proposed in good faith and the plan and its proponent are in compliance with the Bankruptcy Code. A feasible plan is one that is not likely to be followed by liquidation – unless the plan is a liquidating plan – or the need for further financial reorganization. If an objection is not timely filed, the court may confirm the plan without receiving evidence. Fed. R. Bankr. P. 3020(b)(2).

Postconfirmation administration

Confirmation of a plan does not close the case. Fed. R. Bankr. P. 3020(d). After confirmation, the court may proceed to hear and resolve claim objections and adversary proceedings. The debtor must also continue to file financial reports, although on a quarterly rather than monthly basis, and pay United States Trustee fees.

In order to terminate such reporting and payment requirements, the debtor must apply for entry of a final decree following full administration of the case and substantial consummation of the plan. Fed. R. Bankr. P. 3022.

A party in interest may request revocation of the confirmation order within 180 days of confirmation. The court may revoke confirmation "if and only if the [confirmation] order was procured by fraud." 11 U.S.C. § 1144.