



Chapter 11 of the US Bankruptcy Code

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Chapter 11 of the US Bankruptcy Code is a complex insolvency procedure. It is typically used to reorganise a business that is in financial difficulty but may still be viable; the business may be a corporation, sole trader or partnership.

When a business is insolvent, that is to say, unable to pay its debts as they fall due, the business or its creditors have two options: file with a federal bankruptcy court for protection under either Chapter 7 or Chapter 11. Chapter 7 deals with liquidation. Under Chapter 7, the business stops trading and all assets are sold for the benefit of creditors. In contrast, the aim of Chapter 11 is to restructure debts and save the business if at all possible. Under Chapter 11, unless a separate trustee is appointed, the debtor remains in control of the day-to-day running of the business as a 'debtor in possession' subject to the supervision of the court. Businesses are granted court protection and special privileges while they negotiate a plan of reorganisation with creditors. For instance, a debtor in possession can acquire financing for the business by giving new lenders first priority on the earnings of the business (known as 'super priority'). In certain circumstances, the court may also permit the debtor in possession to reject and cancel contracts. Importantly, the business is protected from other litigation whilst in Chapter 11 through the court's imposition of an 'automatic stay' (i.e. temporary stop or 'moratorium'). This means that whilst the automatic stay is in place, most litigation against the debtor in possession is stopped, or put on hold, until it can be resolved in the bankruptcy court. The ultimate aim is for a viable business to emerge intact from Chapter 11 proceedings.

This note provides a brief explanation of how Chapter 11 works in practice. It also provides information on the impact of Chapter 11 in terms of the number of American companies it rescues.

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1 The U.S. Bankruptcy Code

1.1 Overview of the Code

The *Bankruptcy Reform Act 1978* (as amended) is the federal law that governs all insolvency cases, its provisions are referred to as the Bankruptcy Code. The procedural aspects of the bankruptcy process are governed by the '*Federal Rules of the Bankruptcy Procedure*' (more often called the Bankruptcy Rules) and the local rules of each bankruptcy court. The *Bankruptcy Abuse Prevention and Consumer Protection Act 2005* (BAPCPA) has also made some changes to Chapter 11.

The Bankruptcy Code has two main objectives:

- to provide an honest but financially distressed debtor (whether an individual or a business) with a fresh start, and
- to ensure that his creditors participate equally in any distribution which may be forthcoming from the debtor's bankrupt estate

The Bankruptcy Code, which is divided into Chapters, sets out the rules governing particular circumstances.

1.2 Differences between Chapters 7 and 11

The two main Chapters used in corporate insolvency are Chapters 7 and 11.

Chapter 7 deals with liquidation. It offers a basic liquidation process under which a business terminates immediately, control of the firm is transferred to a creditor-appointed trustee, and its assets are sold off for the benefit of creditors.

In contrast, Chapter 11 offers debt restructuring relief to most types of business entities. Businesses are granted court protection and special privileges while they negotiate a plan of reorganisation with creditors. A business may emerge in tact from Chapter 11 proceedings within a few months or within several years, depending on the size and complexity of its financial difficulties.

In effect, the main purpose of Chapter 11 is to rescue a still viable business in financial difficulties. That said it is permissible for an insolvent business to put forward a liquidating plan under Chapter 11 to enable the business to 'wind-up' under more economically advantageous circumstances than under Chapter 7 liquidation. It also enables the creditors to take a more active role in the liquidation of the assets and the distribution of the proceeds than in a Chapter 7 case.

The rest of this note is concerned only with Chapter 11 procedures.

2 How Chapter 11 works in practice

Once a Chapter 11 case has begun, the company's management usually remain in control of assets as the 'debtor in possession' (DIP).¹ The DIP runs the day to day operations of the business while creditors and the debtor work with the bankruptcy court to negotiate and complete a restructuring plan.

Broadly speaking there are three steps involved in Chapter 11 proceedings:

1. Preparation of a business restructuring plan.
2. Confirmation of the plan by the bankruptcy court.
3. Implementation of the plan.

The main characteristics of Chapter 11 proceedings include:

- an automatic stay;
- the retention of existing management;
- the availability of debtor-in-possession financing;
- a prescribed time period for the debtor to propose a plan of reorganisation; and
- the ability to enforce a restructuring plan on dissenting creditors

2.1 Preparation of a business restructuring plan

Petition

To initiate Chapter 11 proceedings, a petition is filed with the bankruptcy court. A petition may be voluntary (meaning that it is filed by the debtor) or it may be involuntary (meaning it is filed by creditors who meet certain requirements). Unless otherwise directed by the court, the debtor company filing a voluntary petition must also file with the court:

- a schedule of assets and liabilities;
- a schedule of current income and expenditure
- a schedule of executory contracts and unexpired leases; and
- a statement of financial affairs

¹ The term refers to a debtor that keeps possession and control of its assets while undergoing a reorganisation under Chapter 11, without the appointment of a case trustee. The debtor will remain a DIP until the debtor's plan or reorganisation is confirmed, the debtor's case is dismissed or converted to Chapter 7, or a Chapter 11 trustee is appointed.

There is often a period of delay between the filing of the Chapter 11 petition and confirmation of a debt reorganisation plan, during which time the day-to-day operation of the business will be carried on by the DIP. However, if there is evidence of mismanagement or fraud, a trustee may be appointed upon the request of creditors. In some limited cases, a committee of creditors may be appointed to oversee the business under the supervision of the DIP once the case has been initiated.

In effect, the DIP is placed in the position of a fiduciary, with all the rights and powers of a Chapter 11 trustee. The DIP is required to perform all but the investigative functions and duties of a trustee. These duties include accounting for property, examining and objecting to claims, and filing information reports (such as monthly operating reports) as required by the court and/or the US trustee.

Automatic stay (moratorium)

Arguably, the most important feature of Chapter 11 proceedings is the 'automatic stay'. The automatic stay provides a period of time in which all judgments, collection activities, foreclosures, and repossessions of property are suspended and may not be pursued by the creditors on any debt or claim that arose before the filing of the Chapter 11 petition. The automatic stay automatically comes into effect when the petition is filed at court. In effect, it provides a breathing spell for the debtor; a period of time in which to restructure the business in order to resolve its financial difficulties.

Avoidable transfers

Another feature of Chapter 11 proceedings is 'avoidable transfers'. In effect, the DIP has the power to undo a transfer of money or property made within 90 days before filing the Chapter 11 petition. By avoiding a particular transfer of property, the DIP can force the return of the payments or property, which is then available to pay to creditors. Any transfers to connected persons (i.e., relatives, directors or officers of the debtor) made up to a year before filing the Chapter 11 petition may also be avoided. The idea behind avoiding powers is to prevent unfair pre-petition payments to one creditor at the expense of all other creditors.

Role of the debtor in possession

As mentioned above, the DIP is responsible for the day-to-day operation of the business. Unless otherwise directed by the court, the DIP may continue to use, sell or lease assets in the ordinary course of business without prior court approval. There are, however, certain restrictions applicable to the use of 'cash collateral'. The Bankruptcy Code defines cash collateral as '*cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents, whenever acquired, in which the estate and an entity other than the estate have an interest.*'² The DIP cannot use, sell, or lease 'cash collateral' unless each creditor with an interest in the collateral consents or unless the court authorises such use. To obtain court permission to use cash collateral the DIP must provide any creditor who holds a charge (or lien) on such property with adequate protection.

In addition to being able to use the business assets, the DIP is also able to borrow funds as operating capital. The lender is given a court-approved 'super priority' over other unsecured creditors or a charge (or lien) on property of the estate.³

Executory contracts (i.e. unfulfilled contracts) may be rejected by the DIP if canceling them would be financially favorable to the company and its creditors. The standard feature of executory contracts is that each party to the contract has duties remaining under the

² Section 363 of the US Bankruptcy Code

³ Section 364 of the US Bankruptcy Code

contract. In the event of a rejection, the remaining parties to the contract become unsecured creditors of the debtor.

Once in Chapter 11, only the DIP may file a plan of reorganisation during the first 120-day period after the petition is filed (or after entry of the order for relief, if an involuntary petition was filed). The court may grant an extension of this exclusive period up to a limit of 18 months after the petition date. If the DIP fails to file a plan within the exclusivity period (plus any time extensions granted by the court) other interested parties (such as the creditors' committee or a creditor) may file a competing plan.

The main purpose of a Chapter 11 plan is to classify claims against the debtor, specify the treatment to be given each class of claim, and outline the means for carrying out the plan. Generally, a plan will classify claim holders as secured creditors, unsecured creditors entitled to priority, general unsecured creditors, and equity security holders.

Once the DIP has filed a restructuring plan, the next step is to obtain the approval of the creditors and the confirmation of the court (see below).

2.2 Role of the US trustee or bankruptcy administrator

The US trustee plays a major role in the Chapter 11 process. The US trustee is responsible for monitoring:

- the progress of a Chapter 11 case and supervises its administration;
- the DIP's operation of the business and the submission of operating reports;
- applications for compensation and reimbursement by professionals;
- plans and disclosure statements filed with the court; and
- creditors committees

The US trustee conducts a meeting of the creditors (often referred to as the 'section 341 meeting') in a Chapter 11 case. At this meeting, the US trustee and creditors may question the DIP under oath about the debtor's acts, conduct, property, and the administration of the case. The US trustee also imposes certain requirements on the DIP concerning matters such as reporting monthly income and operating expenses, establishing new bank accounts, and paying taxes.

Importantly, the US trustee can take action if the DIP fails to comply with any reporting requirements or fails to take the appropriate steps to bring the case to confirmation. The US trustee may file a motion with the court to have the debtor's Chapter 11 case converted to another Chapter of the Bankruptcy Code or have the case dismissed.

2.3 Role of creditors' committees

Creditors' committees can play an important role in Chapter 11 cases. The committee is appointed by the U.S. trustee and usually consists of unsecured creditors who hold the seven largest unsecured claims against the debtor. Among other things, the committee:

- consults with the DIP on administration of the case;
- investigates the debtor's conduct and operation of the business; and
- participates in formulating a restructuring plan for the business

2.4 Confirmation of the plan by the bankruptcy court

Although the creditors will vote on the plan of reorganisation, the court ultimately approves (confirms) or disapproves the plan.

The DIP must first file with the court a written disclosure statement, to provide information on the affairs of the debtor. Assuming the court approves the disclosure statement, the debtor can begin to approach creditors to persuade them to accept the plan, and creditors may also solicit rejections of the plan. The DIP has 180 days after the petition date (or entry of the order for relief, if an involuntary petition was filed) to obtain acceptances of the plan. However, the court may extend this period by up to 20 months.

Under the Bankruptcy Code, approval of a plan requires the agreement of two-thirds of shareholders and each class of creditor. An entire class of claims is deemed to accept a plan if the plan is accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims in the class. If there are impaired classes of claims (i.e. claims that are not going to be paid completely) the court cannot confirm a plan unless it has been accepted by at least one class of non-insiders who hold impaired claims.

Of course, creditors may object to a plan, for example, they may challenge the debtor's valuation of collateral and the feasibility of the plan. Under certain limited circumstances, the debtor business may use so-called 'cram-down procedures'. Cram-down procedures force the non-assenting class of creditors to accept proceeds equivalent to a hypothetical liquidation (according to the rules of absolute priority). In practice, cram-down procedures are only usually used as a threat to persuade dissenting classes to approve a plan, it is rarely necessary to carry through the procedures.

It is also possible that more than one plan may be submitted to the creditors for approval. When competing plans are presented that meet the requirements for confirmation, the court must consider the preferences of the creditors and equity security holders in determining which plan to confirm.

After the disclosure statement is approved by the court and the ballots are collected and tallied, the court will conduct a confirmation hearing to determine whether to confirm the plan. If no objection to confirmation has been filed, the Bankruptcy Code allows the court to determine whether the plan has been proposed in good faith and according to law. In order to confirm the plan, the court must find, among other things, that:

- the plan is feasible (i.e. that confirmation of the plan is not likely to be followed by liquidation (unless the plan is a liquidating plan) or the need for further reorganisation);
- it is proposed in good faith; and
- the plan is in compliance with the Bankruptcy Code

If a plan cannot be confirmed the court may either convert the case to a liquidation under Chapter 7 or, if in the best interests of the creditors, the case may be dismissed resulting in a return to the status quo before insolvency. If the case is dismissed, creditors will look to non-bankruptcy law in order to satisfy their claims.

2.5 Implementation of the plan

Under a confirmed plan, the debtor may be able to reduce its debts by repaying a portion of its obligations and discharging others. The debtor may also be able to terminate burdensome contracts and leases, recover assets, and rescale its operations in order to return to profitability.

The DIP is bound by the provisions of a confirmed plan. The DIP also has a number of responsibilities to perform including:

- implementing the plan and making plan payments (the confirmed plan creates new contractual rights, replacing or superseding pre-bankruptcy contracts);
- reporting on progress; and
- applying for a final decree (a final decree closing the case must be entered after the estate has been fully administered)

It should also be noted that making a confirmation order does not prevent the court from making any other order it considers necessary to administer the estate.

To conclude, under Chapter 11 a viable business that is in financial difficulties normally goes through a period of consolidation and emerges with a reduced debt load and a reorganised business.

3 Statistics on Chapter 11 bankruptcy

Statistics on the number of businesses entering Chapter 11 proceedings in the US is published by the US Courts. The latest data available covers the 12 months to the end of September 2009. Data covering 2002 to 2009 is shown in the table below.

US Business Bankruptcy Filings 2002-2009

Filings in US Bankruptcy Courts
12 months to September each year

	Chapter 11	Other business filings	Total business filings
2002	10,702	28,389	39,091
2003	9,185	26,998	36,183
2004	9,436	25,381	34,817
2005	5,776	28,446	34,222
2006	5,345	21,988	27,333
2007	5,317	20,608	25,925
2008	7,962	30,689	38,651
2009	13,349	45,372	58,721

Note: other business filings covers Chapters 7,12 and 13

Source: US Courts, Bankruptcy Statistics, www.uscourts.gov

With the US economy in recession, numbers of business bankruptcy filings rose sharply in 2008 and 2009. These increases followed a period when numbers of business filing had been falling. The drop in filings following changes to Chapter 11 procedures in 2005 was particularly apparent. Since that date, however, Chapter 11 filings have risen as a proportion of total business filings.

It should be noted that this data excludes non-business bankruptcy filings which make up the majority of total filings but a small part of Chapter 11 filings. In the year to September 2009 there were 1,306 non-business Chapter 11 filings.

Unfortunately, statistics regarding the average length of time businesses spend in Chapter 11 or their success after exiting it are not published.

Further statistics are available at: <http://www.uscourts.gov/bnkrpctystats/bankruptcystats.htm>