June 29, 2009

Confirmed Chapter 11 Plan, But in Distress Again

The available options under the Bankruptcy Code

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Confirmation of a Chapter 11 plan is the mechanism through which a debtor receives a discharge from its preconfirmation liabilities and a fresh start to operate without the protection of the Bankruptcy Code and the bankruptcy court. A Chapter 11 plan contains provisions for the reorganization or liquidation of a debtor's assets, which, if confirmed by an order of the bankruptcy court, will bind the debtor, creditors and other parties in interest.[1]

Upon the entry of a confirmation order, creditors' claims are discharged, the debtor is released from liability, and the debts are replaced by the plan's obligations.

Ordinarily, a confirmed plan of reorganization provides that the reorganized debtor's operations will now be financed by its revenues. However, during this recession a number of reorganized companies have experienced financial difficulties after confirmation of their plans. For example, Goody's LLC and Friedman's Jewelers have each filed for bankruptcy protection for a second time soon after emerging from their first reorganization.

The current environment provides a good opportunity to review the options that are available under the Bankruptcy Code for reorganized companies that become financially distressed after confirmation of their reorganization plans.

Available Options

Different options are available for a reorganized company depending on whether substantial consummation of its plan has occurred. As explained below, determining whether substantial consummation of a plan has occurred is important because it would severely limit the options.

Substantial consummation of a plan occurs when the transfer of all or substantially all of the property proposed by the plan to be transferred is actually transferred; when the debtor (or its successor) has assumed the business of the debtor or the management of all or substantially all of the property dealt with by the plan; and when distributions under the plan have commenced.[2] All three elements must be present to warrant a finding of substantial consummation.[3]

The burden is on the proponent of any modification to a confirmed plan to show that the plan has not been substantially consummated. A Chapter 11 debtor's payments do not have to satisfy a percentage of payments test for a bankruptcy court to conclude that the plan is substantially consummated.[4] Substantial consummation "may occur even though the debtor has not distributed to the creditors substantially all of the amounts called for by the plan because substantial consummation requires only that there was a 'commencement of distribution under the plan.'"[5]

In the event that substantial consummation has not occurred, the proponent of the plan or the reorganized debtor may make modifications at any time after confirmation if the "circumstances warrant such modification and the court, after notice and a hearing, confirms such plan as modified" under §1129 of the Bankruptcy Code. [6]

However, there is a split in authority on whether a debtor's post-confirmation operational losses that render the original plan unworkable constitute circumstances warranting modification of a confirmed plan.

Compare, for example, the differing court opinions in In re Gene Dunavant and Son Dairy, [7] which allowed modification because the debtor suffered substantial post-confirmation losses through no fault of its own, with In re Modern Steel Treating Co., [8] where the court found substantial consummation had not occurred, but still held that the plan could not be modified because the "inability to fund the Plan is not a reason for modification under §1127(b)."

The termination of the right to seek modification upon substantial consummation of the plan is intended to promote the finality of the reorganization process and to avoid prejudice to the rights of the debtor's creditors and equity security interest holders. [9] In the event of default by a reorganized debtor under a confirmed plan, creditors are free to pursue other remedies, such as filing an involuntary Chapter 7 petition against the reorganized debtor or enforcing the plan terms through litigation.

Conversion to Chapter 7

Another option for a debtor unable to consummate a plan is to file a motion requesting that the bankruptcy court enter an order pursuant to Bankruptcy Code §1112 converting the case from Chapter 11 to Chapter 7. This results in the termination of business operations and the appointment of a trustee with a mandate to expeditiously liquidate assets and distribute the proceeds to creditors.

Section 1112(a) of the Bankruptcy Code allows a debtor a nearly absolute right to convert its case at any time unless it was commenced involuntarily under Chapter 11, it was converted to a case under Chapter 11 other than on the debtor's request, or the debtor is out of possession. The right to convert a case to Chapter 7 vanishes, however, upon the substantial consummation of a confirmed Chapter 11 plan because there is no longer a debtor-in-possession.

Section 1112(b) allows a debtor or any other interested party to file a motion to convert the case from Chapter 11 to Chapter 7 for "cause." [10] Section 1112(b) lists 16 non-exclusive examples of acceptable causes, including the inability to "effectuate substantial confirmation of a confirmed plan." [11] However, a finding of cause does not require a court to enter an order converting a Chapter 11 case. [12] Relief is not mandatory, but discretionary.

When Plan Consummated

Conversion under §1112(b) is not an option for a reorganized debtor experiencing financial difficulties after its confirmed reorganization plan has been substantially consummated because there is no bankruptcy estate with assets and liabilities for the Chapter 7 trustee to administer. Moreover, even if cause existed, there is no provision in the Bankruptcy Code that provides for the revocation of the confirmation order and the restoration of the bankruptcy estate upon the conversion of a Chapter 11 case with a consummated plan to Chapter 7. [13]

A reorganized debtor with a consummated plan has just two options under the Bankruptcy Code. These options are filing a successive Chapter 11 or Chapter 7 case.

During the first years after the enactment of the Bankruptcy Code, there was debate over whether §1127(b) precludes a reorganized debtor from filing a second Chapter 11 case because any reorganization plan in the second case would be an impermissible modification of the substantially consummated reorganization plan.

For example, the Northampton court, when declining to permit successive Chapter 11 petitions and converting the case to Chapter 7 for cause under §1112(b), noted that, in some cases, "the filing of a Chapter 11 petition, with an eye toward curing defaults arising under a previously confirmed Chapter 11 plan, is so akin to modifying the previous plan" as to be impermissible. [14]

Today, however, courts generally recognize the need to file a second Chapter 11 case when there have been unforeseen material changes in the company's circumstances and there is a good faith desire to effectuate the aims of the Bankruptcy Code even if that involves the total liquidation of the company's assets.

As stated by one Court of Appeals, a "national consensus permit[s] serial Chapter 11 cases provided the second petition was filed in good faith." [15] Indeed, a second Chapter 11 filing may represent the best chance for the reorganized debtor to restructure its business, resolve disputes and bring about the speedy payment of creditors through the orderly liquidation of its assets.

Goody's LLC and Friedman's Jewelers are examples of successive Chapter 11 cases that have been filed for the purpose of orderly liquidating assets and making distribution to creditors.

The good faith standard protects the integrity of the bankruptcy court and prohibits a debtor's misuse of the process. Courts have held that bad faith constitutes the filing of a successive Chapter 11 case after substantial consummation of a confirmed plan for the sole purpose of renegotiating previously agreed upon plan treatment. Simply stated, courts will find bad faith when the successive Chapter 11 case was filed to avoid what the reorganized debtor "now perceives to be a bad deal" under the consummated plan. [16]

In summary, when considering the above-discussed options for debtors and reorganized debtors experiencing financial difficulties after confirmation of their reorganization plans, a bright line rule emerges that the company's options under the Bankruptcy Code become more limited the closer it comes to consummating its plan.

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Endnotes

[1] See 11 U.S.C. §1141(a).

[2] See 11 U.S.C. §1101(2).

[3] See In re Fansal Shoe Corp., 119 B.R. 28, 30-31 (Bankr. S.D.N.Y. 1990).

[4] See id.

[5] In re Fansal Shoe Corp., 119 B.R. at 30 (quoting United States v. Novak, 86 B.R. 625, 628 (D.S.D. 1988)).

[6] 11 U.S.C. §1127(b).

[7] 75 B.R. 328, 334 (M.D. Tenn. 1987).

[8] 130 B.R. 60, 65 (Bankr. N.D. Ill. 1991).

[9] See In re Rickel & Assocs. Inc., 260 B.R. 673, 680 (Bankr. S.D.N.Y. 2001); see also In re Charterhouse Inc., 84 B.R. 147, 152 (Bankr. D. Minn. 1988).

[10] 11 U.S.C. §1112(b).

[11] 11 U.S.C. §1112(b)(4)(M).

[12] See Loop Corp. v. U.S. Trustee, 379 F.3d 511, 517 (8th Cir. 2004).

[13] See In re K&M Printing Inc., 210 B.R. 583, 584 (Bankr. D. Ariz. 1997).

[14] In re Northampton Corp., 39 B.R. 955, 956 (Bankr. E.D. Pa. 1984).

[15] In re Elmwood Dev. Co., 964 F.2d 508, 511 (5th Cir. 1992).

[16] In re Miller, 122 B.R. 360, 367 (Bankr. N.D. Iowa 1990); see also Lincoln Nat'l Life Ins. Co. v. Bouy, Hall & Howard & Assocs. (In re Bouy, Hall & Howard & Assocs.), 208 B.R. 737, 744 (Bankr. S.D. Ga. 1995).