Introduction

Bankruptcy can be such an ugly word. It conjures up images of failure, liquidation sales, and lost jobs. However, in the right circumstances, bankruptcy – or, better, a business reorganization – can offer a Section 501(c)(3) nonprofit the opportunity to creatively restructure its debts and cash flow so that it may continue serving its clients and community.

Take, for example, the YMCA of Marquette County. It was saddled with $4.8 million of debt and facing a possible dissolution when it filed for Chapter 11 relief in May, 2017. A little more than a year later it emerged from the process as a successfully reorganized business that is still fulfilling its mission in the Upper Peninsula.

Not all Chapter 11s are as successful as the YMCA of Marquette County. However, debtor relief, whether in or outside the context of a bankruptcy proceeding, is an option that should be explored by all nonprofit organizations that find themselves struggling due to the pandemic. Now is also the time to begin informing oneself of its potential because, as any financial expert will advise, timing can mean all the difference between success and failure.

What follows are FAQs designed to answer many of the questions that might be asked when first consulting with a professional about how to address your organization’s financial difficulties. Hopefully, they will help facilitate those conversations.

FAQ’s

1) What is bankruptcy?

A bankruptcy is a federally supervised proceeding that is overseen by a single court – the bankruptcy court. The proceeding is intended to bring within that court’s authority most (but not necessarily all) matters that relate to the debtor organization’s financial affairs. The administration of the bankruptcy proceeding is dictated by the Bankruptcy Code, related rules, and court-issued opinions.
2) Is bankruptcy relief even an option for non-profit 501(c)(3) organizations?

Yes, most Section 501(c)(3) organizations have the same opportunities for bankruptcy relief as do ordinary businesses.

3) What are the different types of bankruptcy proceedings?

There are only two categories of bankruptcy proceedings – Chapter 7 and Chapter 11 – that are suitable for Section 501(c)(3) organizations. The other categories – Chapter 9, 12 & 13 – are only available for municipalities, farmers/fishermen, and individual wage earners, respectively.

Congress recently added to Chapter 11 a new Subchapter V that is to streamline the Chapter 11 process for a small Section 501(c)(3) organization that is engaged in a business activity. Subchapter V reorganizations are discussed more in later FAQs.

4) How is a Chapter 11 bankruptcy proceeding different from a Chapter 7 proceeding?

A Chapter 7 almost always involves a liquidation of the organization’s assets by a court appointed trustee with the proceeds realized then being distributed to the organization’s creditors. A Chapter 11 most often involves an operating organization whose goal is to continue operating after re-emerging from the proceeding with restructured debt. Individuals may also seek Chapter 11 relief and a Chapter 11 proceeding could involve liquidating some or all of the organization’s assets.

Some particularly unique features of a Chapter 11 are a) the debtor often continues to operate the organization during the bankruptcy proceeding as the so-called “debtor-in-possession”; b) one or more groups of creditors have the option of participating in the proceeding as “creditor committees”; and c) the proceeding culminates in a “plan of reorganization” that is voted upon by the debtor’s creditors and then “confirmed” (or not) by the bankruptcy court.

5) How might a 501(c)(3) Chapter 11 reorganization be different from the Chapter 11 reorganization of an ordinary business?

One advantage a Section 501(c)(3) has over an ordinary business is that a Section 501(c)(3) is exempt from paying most federal, state and local taxes. Therefore, a 501(c)(3) usually has one less creditor group to contend with than does an ordinary business provided all.

A Section 501(c)(3)’s board of directors is often much larger than an ordinary business’s board and a Section 501(c)(3)’s board also tends to give less operating discretion to the organization’s executive director. This can present practical problems when, for example, negotiations with a particular creditor requires quick and decisive action.

A Section 501(c)(3), unlike an ordinary business, has no “owner”. Therefore, a Section 501(c)(3) does not risk having its ownership change as a result of the bankruptcy
proceeding. However, there is still the risk that the Section 501(c)(3)’s board membership could be changed.

And finally, many 501(c)(3)s have a revenue source that ordinary businesses do not – donations and fundraisers. Filing for Chapter 11 relief can risk losing the organization’s donor base, especially if its donors perceive the filing as a last desperate effort. However, if managed properly, the 501(c)(3)’s donor base could provide the necessary cash boost to get through the Chapter 11 process.

6) What are some of the other advantages of a bankruptcy proceeding?

One huge advantage is that the commencement of a bankruptcy proceeding automatically stops most creditor activities against the debtor organization (e.g. foreclosures, evictions and lawsuits) so that the debtor organization can catch its breath and focus on finding a solution to its financial problems. The statutory mechanism in the Bankruptcy Code that stops these creditor activities is called the “automatic stay”.

A bankruptcy proceeding also gives the debtor organization the opportunity, if it wishes, to restructure its debts so that it may continue to operate. This is called a “reorganization”.

7) What are some of the other disadvantages of a bankruptcy proceeding?

One disadvantage of a bankruptcy proceeding is that there are rules to be followed and reports that must be filed. Creditors also can use the proceeding to protect their own rights, which can be distracting and even disruptive.

Another disadvantage is that it is very difficult to stop a bankruptcy proceeding once it begins. Filing for bankruptcy relief is much like entering a tunnel that can be exited only at the other end, for better or for worse.

8) Should my organization consider filing for bankruptcy relief now or should it wait?

Generally, the risk of getting trapped in a supervised court proceeding with no escape dictates waiting until all other available options are exhausted.

9) What is a forbearance agreement?

A forbearance agreement is any out-of-court arrangement reached with a creditor that stops that creditor from taking an action against your organization. A forbearance agreement can be as simple as waiving a late fee or postponing this month’s rent to completely restructuring the terms of a bank loan or a lease.

Negotiating one or more forbearance agreements may be enough for your organization to survive without having to file for bankruptcy relief. However, even if bankruptcy is still needed, an earlier forbearance agreement could still be incorporated into your organization’s Chapter 11 bankruptcy plan.
Always think carefully about when to ask for a forbearance agreement and what include in that agreement because the creditor may be less inclined to make an accommodation a second time. It is also wise to have at least some idea of how that creditor would be treated in a plan if your organization were to file for Chapter 11 relief instead. These are both reasons why seeking professional advice early is so important.

10) My organization has only a limited amount of cash. To which of my creditors should I give priority if I decide to continue operating outside of a bankruptcy proceeding?

The short answer is a) pay only those creditors your organization absolutely needs to pay in order to continue operating; and b) pay only as much to those critical creditors as they demand. Critical creditors typically include lenders who hold a security interest in your accounts receivable, inventory or other vital assets (e.g. equipment or building), your landlord, your employees, and any vendor whose product or services is necessary for continued operations.

The taxing authorities are another important group of creditors to consider giving priority because they will receive preferred treatment over general unsecured creditors should a later bankruptcy proceeding be filed. It is especially important to be current on employee income tax withholdings, the employee portion of other employment taxes, and sales taxes because these taxes could be assessed against you personally if not paid.

11) When should my organization hire an attorney or other professional and what should I be looking for in that person?

Seeking advice from a professional with experience assisting financially distressed businesses or organizations is crucial. That professional is often an attorney because of the creditor negotiations and court proceedings that inevitably arise whenever a business or organization is having financial problems. The professional should also be familiar with the local courts (including the local bankruptcy court) and the professionals most likely to be representing your bank, your landlord and your critical vendors.

While someone other than an attorney may be able to advise you outside of a bankruptcy proceeding, your organization must be represented by an attorney once a bankruptcy is filed.

12) What are the things that might make me, as the executive director, seriously consider seeking bankruptcy relief for my organization?

Most often it is a catastrophic event – the bank’s termination of a line of credit, a creditor’s imminent seizure of critical assets, or a threatened eviction - that precipitates serious consideration of a bankruptcy filing. That is because the automatic stay imposed upon the filing of the bankruptcy case will avert the catastrophe at least temporarily.

However, there could also be other reasons for filing. For example, improved future prospects might warrant using the bankruptcy process to address unpaid debt that would otherwise impede taking advantage of those prospects. Conversely, having no future prospects might warrant using the bankruptcy process to bring operations to an efficient and orderly end.
13) At what point would filing for bankruptcy relief be my organization’s only option?

   Any creditor action that threatens continued operations will likely require an immediate bankruptcy filing in order for the bankruptcy’s automatic stay to eliminate that threat. Short of that, filing a bankruptcy can ordinarily wait until a) filing is to your organization’s advantage; or b) all other options have been exhausted.

14) Do I need to file for bankruptcy relief if my organization is closed and will not open?

   Generally, no. However, a Chapter 7 bankruptcy liquidation by a court appointed trustee might be more efficient and less stressful than if you were to oversee the liquidation yourself.

15) Can a bankruptcy proceeding stop a foreclosure proceeding, an eviction proceeding or a vehicle/equipment seizure that has already been commenced by the bank/landlord/finance company?

   Yes, the automatic stay that is imposed immediately upon the filing of any bankruptcy proceeding will stop at least temporarily each of these activities provided that not too much time has passed. For example, little can be done if bankruptcy is not filed before the seized or foreclosed property has been sold or before the reinstatement period on a lease has expired.

16) If my organization were to file for bankruptcy relief, would the bankruptcy proceeding also protect my organization’s bank from proceeding against me on a personal guaranty?

   Unfortunately, the answer is almost always no. However, the lender or other creditor might still be willing to forbear or even waive liability if communications between the two of you have been good and the lender/creditor believes that it is to its advantage not to proceed on the guaranty – e.g. the principal debt can be paid over time as part of a promising reorganization that requires your personal involvement.

17) If my organization were to file for bankruptcy relief, would the filing affect my personal credit?

   The bankruptcy filing of your organization should not affect your personal credit unless you guaranteed some of your organization’s debts. Unpaid tax obligations for which you may be personally liable – e.g., employee tax withholdings – might also affect your credit rating if your organization filed for bankruptcy relief and those obligations remained unpaid.

18) If my organization has decided to consult an attorney about filing for bankruptcy relief, what records and documents should I as the executive director be prepared to provide the attorney before we meet?

   Be prepared for your attorney to want anything and everything. However, the following will make at least the first few meetings quicker and more efficient:
• The past year’s and year-to-date's income statements and balance sheets;
• The most recent Form 990;
• An account payable aging;
• Conservative income and cash flow statements for the next 12 months;
• A list of all lenders with the amount of each debt, the monthly payment, the collateral securing the debt, the number of months (if any) in default, and whether there is a forbearance agreement.
• A list of all leased real estate with the name of each property’s landlord, the monthly rent, the number of months (if any) in default, whether there is a forbearance agreement, and whether taxes, insurance and/or utilities are the landlord’s obligation or your organization’s;
• A list of all leased equipment with the name of each lessor, the monthly lease payment, the number of months (if any) in default, and whether there is a forbearance agreement;
• A list of vendors whose goods or services are critical to your business’s success and identify on that list those vendors (if any) who have threatened to stop shipments or services or have demanded different payment terms;
• A list of pending lawsuits and judgments (if any) and the status of each;
• A list of all out-of-the-ordinary payments made to non-related parties and a separate list of all payments of any kind to officers, directors, members or their respective family members.

19) If I decide it is time to seek bankruptcy relief for my organization, what will be expected of my staff and me in preparation for filing the actual proceeding?

A Chapter 11 proceeding can be time-consuming, especially during the weeks immediately before and after the filing. The biggest demand will be upon you as the executive director and upon those who will be gathering the financial information needed to prepare the required schedules and statement of financial affairs. The information that must be compiled includes a list of all of your organization’s assets and their values and a list of the names and addresses of all of your organization’s creditors with the amounts owed.

You can reasonably expect that an additional 10 to 15 hours will be needed per week for about a month both before and after the case is filed. Moreover, you should expect that these timeframes (but not the hours) will be compressed if it is an unplanned filing – e.g., the bank unexpectedly cancels your line of credit.

20) How would an attorney representing my organization be paid if it were to file for bankruptcy relief?

Your attorney will often ask for a retainer upfront to cover all services expected to be performed both before filing and immediately afterwards. Fees not covered by the retainer will be paid as part of the bankruptcy proceeding but only after court approval. Before the end of your first meeting you should ask for the rates of all of the law firm’s attorneys and paralegals who will be involved in your case and the retainer, if any, the firm will require.
21) Would there be other professional fees associated with my organization’s bankruptcy proceeding and how would those professionals be paid?

Other professionals might be required if your organization were to pursue a Chapter 11 financial reorganization. For example, your organization might need an accountant or consultant to prepare financial projections or an appraiser to value the organization’s assets. As with your attorney, these professionals would ordinarily be paid from your organization’s Chapter 11 operations.

Your bank will likely retain counsel and some of your organization’s other large creditors might be represented. It is also likely that any written agreement your organization has with a creditor includes adding attorney fees to the debt. However, as a practical matter, attorney fees are a concern in a Chapter 11 proceeding only if the creditor is secured and the value of its collateral is more than what is needed to pay in full what is owed that creditor.

22) My organization is currently closed because of the virus. If it were to file for Chapter 11 bankruptcy relief now, would it be able to re-start operations later?

Yes, although it may have to do so quickly because a small 501(c)(3) organization likely would have to file its plan within 90 days. Therefore, unless the protection of the automatic stay is needed immediately, it would be best to wait to file until after your organization is operating again.

23) My organization is still operating. May it continue operating after the bankruptcy proceeding begins?

Most organizations that file for Chapter 11 relief continue operating after the case is filed. However, organizations that file in order to liquidate under Chapter 7 rarely operate after the case is commenced.

24) If my organization were to file for Chapter 11 relief, who will operate it while it is in the bankruptcy proceeding?

Existing management ordinarily continues operating the organization during the Chapter 11 as the so-called “debtor-in-possession”. Apart from some additional reporting requirements, day-to-day operations should remain mostly the same. However, out-of-the-ordinary business decisions like the sale of an asset or establishing a post-petition line of credit would have to be approved by the bankruptcy court after a hearing.

The bankruptcy court would also likely appoint a trustee (or, in some instances, a creditors committee) to regularly assess the organization’s operations and its ability to propose a successful plan.

25) What is a “security interest” and what is a “secured lender”?

A creditor takes a “security interest” in some or all of your organization’s property so that it may later enforce that interest to collect its debt should your organization be in default. The security interest can be in a single asset, some assets, or all of your organization’s assets.
The security interest allows the creditor to seize the property in which the interest has been granted and then sell it for payment against what is owed.

A security interest in most types of property – e.g., accounts receivable, inventory, vehicles, and/or equipment - is created by a “security agreement”. However, a security interest (or “lien”) in real property – e.g., land or a building - is created by a mortgage. “Lien” is also used to describe an involuntary security interest taken in any type of property – e.g. a tax lien or a judgment lien.

“Secured lender” is often used in a bankruptcy proceeding to describe a bank or finance company that has a security interest in your organization’s property to secure a loan.

26) What additional responsibilities would my staff and I have if my organization were to file for Chapter 11 bankruptcy relief?

Operations often return to some semblance of normalcy a few weeks after the case is filed, with the only extra demands being whatever reporting requirements have been agreed upon or ordered. However, there can be spurts of very intense activity should, for example, a dispute arise with your secured lender concerning continued use of your cash for operations or should your landlord want permission from the bankruptcy court to commence eviction proceedings. Demands for your staff’s and your time will also increase as you prepare your plan, have it approved, and then administer it.

27) How is a bankruptcy proceeding commenced?

A bankruptcy is commenced simply by filing a “petition for relief”, which is a two- or three-page document that includes the chapter of relief requested (e.g., Chapter 11) and some other basic information. No court hearing is required. The case simply begins.

The petition must be accompanied by a list of your organization’s 20 largest creditors and a few other documents together with a $1717 filing fee. The organization’s schedules and statement of affairs, which is essentially a financial questionnaire, can also be filed with the petition but it is often filed shortly after the filing because of the amount of time required to prepare it.

And finally, other documents, some routine and some more complicated, are frequently filed on the same day the petition is filed. These documents are needed to conform the organization’s operations to the requirements of the Chapter 11 proceeding.

28) Can a bankruptcy proceeding be conducted in private?

No. With rare exception, everything that is filed in a bankruptcy proceeding is available to the public and can even be examined online.

29) Must I or my staff appear in court if my organization were to file for bankruptcy relief?

There are two, relatively informal informational meetings – known as the initial debtor interview and the first meeting of creditors – that you as the executive director must attend
and answer questions posed by creditors and others interested in your organization. Your attendance at a contested hearing might also be required, especially if your testimony is needed. And finally, you would likely be called to testify at the confirmation hearing – i.e., the hearing to approve your organization’s plan – even if the plan is uncontested.

30) What might happen during the first two weeks of my organization’s bankruptcy proceeding?

The first few weeks are busy and at times frustratingly distracting. Various parties will want financial information, new bank accounts will need to be opened, and new reports and reporting procedures may have to be developed.

31) Will revenues decrease if my organization were to file for Chapter 11 bankruptcy relief?

Although bankruptcy is a public proceeding, your customers/clients will often not know that you have filed for relief. Revenues may decline, though, if a major customer or client learns of the proceeding and decides to take its business elsewhere.

32) What additional demands on cash flow might my organization expect if it continued operating after filing for Chapter 11 relief?

It is common for vendors to change credit terms to cash-on-delivery (“COD”) if they have not already done so prior to the commencement of the case. Additional cash will also be required to pay professionals (e.g., your attorneys), especially if the case becomes adversarial.

33) Will my organization’s cash flow be affected if the bank has a security interest in my organization’s accounts receivable?

Accounts receivable, together with inventory and cash generated from those receivables and inventory, held at the commencement of the bankruptcy proceeding is referred to as “cash collateral”. If a bank (or other lender) has a security interest in any part of the cash collateral, then an agreement must be reached with the bank either before the bankruptcy is filed or immediately after the filing. Otherwise, cash cannot be used without the bankruptcy court’s approval. The court will make its decision very quickly if an agreement cannot be reached.

Although each situation is different, the “cash collateral” agreement (or order if the court makes the decision) will typically focus on your organization’s ability to operate during the Chapter 11 proceeding without depleting the cash collateral’s value. That ability is often established by demonstrating that post-petition sales/services will generate enough new cash and accounts receivable to replace the existing cash and accounts receivable your organization needs to continue operating post-petition.

34) After filing for bankruptcy relief may my organization pay its employees for wages earned before the bankruptcy petition was filed?

The bankruptcy court will typically allow the current pay period to be paid in full when due if that pay period “straddles” the date the Chapter 11 was filed. Beyond that, wages earned
pre-petition cannot be paid until the Chapter 11 plan is approved, with those wages being given priority up to $13,650 per employee but only if earned within 180 days of the commencement of the case.

35) What if a critical vendor refuses to continue doing business after the bankruptcy petition is filed?

Generally, a vendor, whether critical or not, has no obligation to provide goods or services post-petition. Fortunately, most vendors are willing to continue doing business on a COD basis. The bankruptcy court on rare occasions may also order the vendor to continue doing business if the particular good or service is critical and cannot be obtained from any other source.

36) What if a vendor will continue doing business but only if it is paid what is currently owed?

While a vendor may refuse to continue providing goods or services because of a bankruptcy, a vendor generally cannot condition post-petition performance upon payment first of what was owed pre-petition. There are, though, exceptions. One is when there is a long-term contract and your organization wants the vendor to continue furnishing goods or services under that contract. Another rare exception is when the court determines that the goods or supplies are so critical and unique that it is appropriate to give in to the vendor’s demand.

37) Could a vendor change its payment terms to COD if my organization were to file for bankruptcy relief?

Yes, and most vendors do if they have not already done so before the filing. However, there could be an exception if the payment terms are part of a long-term contract still in effect at the time of the bankruptcy filing.

38) Could a utility cut off service if my organization were to file for bankruptcy relief?

No, but a utility may require a deposit (often around two months of average costs) to continue providing service post-petition.

39) Will my organization be able to continue borrowing on its line of credit after filing for Chapter 11 bankruptcy relief?

Lines of credit seldom continue once a bankruptcy proceeding begins. Instead, the bank will agree to (or, if appropriate, be ordered to accept) an arrangement for your organization to use cash with the bank in turn being granted a security interest with terms designed to protect its position in your organization’s cash and accounts receivable. See also FAQ 33. Establishing these post-petition terms is one of the first things that must be addressed after filing.

40) Will the bankruptcy court permit my organization to establish a new line of credit with another lender?

Yes, but finding a willing lender with acceptable terms can be challenging.
41) Could a bank or finance company with a security interest repossess my organization’s vehicles or other equipment after the bankruptcy case is filed?

The answer is almost always no at the outset of the case due to the immediate effect of the automatic stay. However, your organization may be required to pay some amount to the bank or finance company to cover depreciation in value of the vehicles or equipment and your organization may also be required to pay interest if the value of the vehicle or equipment is more than the amount owed. Moreover, the likelihood of the court permitting the vehicle or equipment to be seized will increase the longer your organization remains in the Chapter 11 proceeding without a plan of reorganization being approved.

42) Could a bank with a mortgage in my organization’s building foreclose that mortgage after the bankruptcy case is filed?

As with vehicles and equipment, the answer is almost always no at the outset of the case because of the automatic stay. Your organization may, though, be required to pay some amount to cover depreciation in value and your organization may also be required to pay interest if the value of the building is more than the amount owed. Also, the likelihood of a foreclosure being allowed will increase the longer your organization remains in the Chapter 11 proceeding without a plan of reorganization being approved.

43) Will my landlord be able to evict my organization from its leased premises after the bankruptcy case is filed?

The automatic stay also prevents your landlord from commencing or continuing an eviction proceeding after the bankruptcy is commenced. Your organization should, however, expect to continue paying post-petition rents and its other obligations under the lease (e.g. taxes, insurance and/or utilities).

44) Would filing a Chapter 11 proceeding create any licensing problems (e.g. operating a regulated care facility)?

No. Government agencies may not discriminate against an organization solely because it is in a Chapter 11 proceeding.

45) Could filing a Chapter 11 proceeding affect the funding my organization receives from federal or state agencies or from private foundations?

A government agency may not stop funding solely because the organization is in a Chapter 11 proceeding. However, issues arising from the filing could trigger other legitimate reasons for terminating or modifying funding. Therefore, you should review the grant closely before commencing a bankruptcy proceeding. The same applies to private foundations.

46) Would an endowment or restricted gift be affected if my organization were to file for Chapter 11 relief?
Your creditors may argue that a restricted gift or endowment should be used for their benefit, especially if your creditors are not to be paid in full under the proposed plan of reorganization. Your organization’s chances of defeating that argument will depend upon a) the specificity of the restrictions; b) how well your organization has honored those restrictions; and, c) whether the endowment (or a restricted cash gift) has been commingled with other cash in a single account.

47) How would my organization successfully end a Chapter 11 proceeding?

The goal of a Chapter 11 proceeding is to have the bankruptcy court “confirm” (i.e. approve) a plan that eliminates or restructures enough of your organization’s debt for it to continue operating successfully after it emerges from the proceeding.

48) Are there different types of Chapter 11 plans?

There are generally two types of Chapter 11 plans – reorganizing and liquidating. A plan of reorganization rearranges the organization’s debt with its creditors by eliminating all or a portion of the debt and/or establishing new repayment terms. The reorganized debtor is then obligated to satisfy whatever payments the approved plan requires in order to re-emerge as a successfully “reorganized” entity.

A liquidating plan ordinarily involves the transfer to a third party of the organization or its assets as an on-going operation. The Chapter 11 proceeding is used simply as a vehicle to keep the organization operating until a third-party purchaser is found.

There can also be combinations of liquidating and reorganizing plans. For example, the plan may contemplate both the sale of the organization to a third party and some type of restructuring of the debt as part of that sale. Or the plan may provide for a portion of the organization to be sold with the remainder continuing to operate under whatever terms the reorganization part of the approved plan provides.

49) Can small organizations elect to be treated differently than larger entities in a Chapter 11 proceeding?

Until recently, a Chapter 11 reorganization was a “one size fits all” proceeding that included a number of procedures designed for large, publicly held corporations requesting Chapter 11 relief. Unfortunately, many of those procedures are not needed when a small organization is involved. To remedy this problem, Congress recently amended Chapter 11 to permit smaller entities to elect a somewhat different (and hopefully easier) procedure to reorganize. Practitioners refer to this amendment as “Subchapter V”.

Ordinarily, your business’s total debt (both secured and unsecured) cannot exceed $2,725,625 in order to be eligible for Subchapter V treatment. However, the even more recently enacted CARES Act has temporarily raised the eligibility ceiling on debt to $7,500,000.
A “Subchapter V” Chapter 11 can be accomplished without creditor committees, disclosure statements, and creditor voting, all of which can be expensive and time-consuming.

Because these FAQs are intended to inform organizations that should easily be within the current $7,500,000 debt ceiling and likely even the more restrictive $2,725,625 debt ceiling, the remaining FAQs will assume that your organization has elected to reorganize as a “small business” that is eligible for this different “Subchapter V” Chapter 11 treatment.

50) How soon must my organization file a plan of reorganization?

A Chapter 11 small business plan must be filed within 90 days. The court may grant an extension but only if your organization was not responsible for the delay.

51) What is typically included in a Chapter 11 plan for an organization like mine?

The “plan” portion of Chapter 11 small business plan usually establishes five creditor categories – administrative expenses, secured creditors, landlords/equipment lessors, priority unsecured creditors, and general unsecured creditors – and then describes how a creditor placed in each category will be paid under the proposed plan.

A Chapter 11 small business plan must also include a “disclosure” section that sets forth a) a brief history of the organization’s operations; b) an estimate of how much would be realized by creditors if the organization were to close and be liquidated; and c) projections about the organization’s future ability to both operate and make all of the payments proposed under the plan.

52) What are administrative expenses and how are they to be treated under a plan?

Administrative expenses include all of the expenses incurred after the commencement of the Chapter 11 case that remain unpaid at the time the plan is approved. They can include unpaid operating expenses, unpaid taxes, and unpaid professional fees. Administrative expenses must be paid in full, albeit repayment can be stretched out over the term of the plan. It is unusual for the amount of administrative expenses at confirmation to be large because post-petition vendors seldom extend credit and most professional fees would have already been paid either by a retainer or as an ongoing operating expense.

53) How are secured creditors treated under a plan?

A plan treats each secured creditor separately with a particular secured creditor typically receiving either a) everything it is owed together with interest over a reasonable period of time IF the collateral’s value is greater than the amount owed; or b) only the value of its collateral together with interest over a reasonable period of time IF the collateral’s value is less than the amount owed. The rate at which the collateral’s value is expected to decline often dictates how long your organization will have to repay the secured creditor’s claim. If the secured portion of the secured creditor’s claim is less than the total amount owed, then the difference will ordinarily be deemed a general unsecured claim and treated separately under that category.
54) How are landlords and equipment lessors treated under a plan?

If your business wants to continue leasing its premises or equipment, the plan must provide that all past due rent or lease payments be paid immediately. Otherwise, the property leased must be returned and the landlord/lessor’s claim for damages will be included among the rest of the general unsecured claims.

55) What are unsecured priority claims and how are they treated under a plan?

Certain types of unsecured creditors are given priority over the remaining unsecured claims, with “priority” meaning that these unsecured creditors must be paid in full. The most common unsecured priority claims are a) unpaid taxes incurred pre-petition; and b) up to $13,650 in unpaid pre-petition wages earned within 180 days of the commencement of the case.

While unsecured priority claims can be paid immediately, a plan typically provides for payment in installments over the length of the plan.

56) What are general unsecured claims and how are they treated under a plan?

General unsecured creditors are all the remaining creditors with pre-petition claims against your organization. Unpaid vendors usually represent most of the organization’s general unsecured creditors. However, general unsecured creditors may also include employees whose wages are not entitled to priority, landlords/lessors whose property will not continue to be leased under the plan, and the remainder of what a secured creditor is owed if the amount of its claim exceeds the value of its collateral.

General unsecured creditors frequently receive only a fraction of what they are owed, with that fraction often being paid in installments over the length of the plan. In a small business Chapter 11: a) the total amount paid to general unsecured creditors must be at least equal to what your organization earns over the “life” of the plan after making all the other required plan payments; b) the life of the plan must be at least 3 years and perhaps up to 5 years; and c) each general unsecured creditor’s share must be proportionate to the amount that creditor is owed.

57) What if I disagree with the amount a creditor claims it is owed?

Another advantage of a Chapter 11 proceeding is that virtually all disputes with creditors are decided by the bankruptcy court in a relatively efficient manner. The schedules your business prepared at the outset of the proceeding dictates what each creditor is owed absent a “proof of claim” being filed by that creditor. That proof of claim will in turn be determinative unless a written objection is made. If there is an objection, the claim’s amount would be determined either by a settlement among the parties or by the bankruptcy court after a hearing.

58) May my organization’s plan propose paying more to some general unsecured creditors – e.g. critical vendors - than the rest?
Generally, no. However, you should discuss this with your attorney because there are some exceptions.

59) How is a Chapter 11 small business plan approved?

Unlike an ordinary Chapter 11 proceeding, the court in a small business Chapter 11 “confirms” (i.e. approves) a plan by deciding at a hearing whether a) each category of creditors is being treated consistent with criteria established by the Bankruptcy Code; and b) whether the plan as proposed is feasible – that is, whether the business has a reasonable likelihood of successfully continuing operations and making all of the payments required by the plan. Any creditor can challenge a) how its claim has been categorized; b) whether its treatment under a category meets the criteria required for that category; and/or c) the plan’s feasibility. The panel trustee overseeing the proceeding may also disagree with either the plan’s provisions or its feasibility.

Most (and sometimes all) of these issues are resolved beforehand, thereby narrowing considerably what must be decided at the actual confirmation hearing. However, the court itself may also raise the same issues at the hearing.

60) Could my organization negotiate, for example, how my bank or landlord is to be treated under a plan of reorganization even before the Chapter 11 case is filed?

Yes. Negotiating plan treatment pre-filing is common and often minimizes the duration and cost of a Chapter 11 proceeding.

61) Could a Chapter 11 plan, if approved, permit my organization to remain at the location it currently leases even if the landlord objects?

Yes. See FAQ 54.

62) Could the Chapter 11 plan, if approved, permit my organization to cure an earlier default with my bank or even permit it to repay its loan to the bank under different terms?

Yes. See FAQ 53.

63) If the Chapter 11 proceeding is not going well and/or a Chapter 11 plan cannot be confirmed, may I dismiss it?

Yes, but dismissal is not automatic. Rather, a hearing would be required and at that hearing the court would consider whether dismissal was in the best interests of your creditors. Alternatives to dismissal include replacing management with a court-appointed trustee or closing the organization and having it liquidated in a Chapter 7 proceeding.

64) If the Chapter 11 proceeding is not going well and/or my organization is unable to confirm a Chapter 11 plan, is it possible that I might no longer be able to operate it?

Yes. Your organization’s creditors could ask the court a) to stop operations and have your organization liquidated as a Chapter 7 case; b) to turn management over to a court-
appointed trustee; or c) to dismiss the case altogether. You would, though, have an opportunity to object at a hearing.

65) What are the chances of my organization successfully reorganizing through a Chapter 11 proceeding?

It is best to answer this question by first emphasizing that Chapter 11 is not itself a solution. Rather, it is better to view Chapter 11 as a tool which, under the right circumstances and in the right hands, can be used to reach a favorable solution.

A key element to a successful Chapter 11 reorganization is your organization’s future prospects. If it was struggling to break even before the COVID-19 crisis, a Chapter 11 may not be of much help. On the other hand, if the economic lockdown is the cause of your current problems, then Chapter 11 may allow your organization the opportunity to successfully re-emerge when the economy improves.

A related issue is liquidity. Chapter 11 proceedings are notoriously cash hungry. This is because a) credit is tight; b) Chapter 11 inevitably involves professional assistance, which can be expensive; and c) additional cash must be generated to fund whatever is to be paid creditors under the terms of the confirmed plan.

And finally, capable management is critical, for it will be called upon to do at least three things simultaneously - a) maintain current operations at or above break-even with as little disruption as possible; b) make realistic and reliable forecasts of the organization’s future prospects; and c) work effectively with the organization’s own professionals and with its creditors to quickly develop and confirm a feasible plan.

The answer, then, is “it depends”, with the chances of success improving the more these three factors are in your organization’s favor.

*The West Michigan Chapter of the Federal Bar Association serves the western half of Michigan's lower peninsula and the entire upper peninsula. Its member attorneys all practice before the federal courts serving the same area. Members who specialize in bankruptcy law belong to the chapter's Bankruptcy Section. The WMCFBA and its Bankruptcy Section support their members through educational programs, practice development, professional recognition and social events. Their members also provide pro bono legal representation and other related services to the community.

The WMCFBA has provided these FAQs and all related materials, information, and resources (collectively the "FAQs") for the sole purpose of informing the public generally. No one should rely upon the FAQs as legal advice and there is no guaranty that the information contained in the FAQs is correct, complete or up to date. Reliance upon the FAQs is not a substitute for the advice of an attorney nor does their use create in any way an attorney-client relationship between that person and the FAQs' contributors, the contributors' law firms, the WMCFBA, or its members. Moreover, the work product and opinions set forth in the FAQs are those of the individual contributors and are not necessarily those of the WMCFBA, its officers, or its other members. The WMCFBA and its members and the FAQs’
contributors and their law firms expressly disclaim liability with respect to any decision made or action taken based only upon information contained in the FAQs and they all strongly recommend that anyone using the FAQs seek the advice of a qualified attorney regarding its particular situation, problem or issue before making a decision or otherwise acting.