



Chapman, Spira & Carson, LLC

## Reorganization And Restructuring

Years before "Downsizing" became fashionable, our reorganization and bankruptcy professionals assisted business in reordering and financial institutions and other creditors in refinancing or "working-out" loans

Bankruptcy regulations in the United States whether it be regarding corporations or individuals are skewed in order to provide the failed entity a new chance to make things work. This is a wonderful philosophy which differs dramatically from the historic treatment of failed individuals and enterprises. The Federal Code provides protection to those going through reorganization that has to some degree been almost lopsided in its efforts to create a smooth road back to fiscal responsibility. From the Government's point of view, each salvation becomes ultimately another taxpaying citizen. Thus, bankruptcy reorganization to some degree has created an unlevelled playing field and given the edge to the given a substantial business advantage to the reorganizing entity, often to the chagrin of competitors.

In businesses, fresh start accounting allows certain assets to be written up. These same assets, if the company had been operating on a continuing basis would have long ago disappeared within the depreciation section of the balance sheet and income statement. During the period of time when a company has been granted court permission to reorganize under the provisions of the bankruptcy code, various expenses are stayed, such as rent and interest, and very often the company can become more profitable under the reorganization than it had been previously.

There are various forms of bankruptcy reorganization and they are called chapters. Chapter seven, is an involuntary bankruptcy in which creditors get together and say, "we are never going to get repaid our money, let's join together and file a common motion to put this entity into receivership. (generally speaking it takes three creditors to put a company into what they call involuntary bankruptcy, Chapter 7) We'll divide up what is in the pot and take our lumps, It's the best we can do". Usually, chapter seven is a last resort and only occurs when the debtors promises have been made and not kept.

In spite of intransigence on the part of the debtor, or even outright lying, the court will usually let him propose some kind of reorganization.

(The Plan) The creditors usually look upon this type of action as having the potential of dissipating even more of their assets and leaving them with even less. Chapter 7 usually occurs after the creditors have lost confidence in what the debtor is telling them and they have no longer have and confidence that he is capable of running a profitable business. Even so, the bankruptcy court will listen to a petition by the debtor to reorganize himself or his entity under his own guidance. What the court will indicate is, the creditors are lawfully owed the money and the debtor is in default. He will further adjudicate that one more chance should be granted.

As usual, the creditors are not pleased. Why should they wait even longer to be paid? So the judge says: "What are we going to do for these people? They entered into legitimate contracts to provide you with product, which they did. I want your to give me a plan that show me how they may wind up being better off than they are right now. Make sure you illustrate who things are going to be different this time around. If I am going to risk their assets, I have to feel that there is a chance that you will succeed in turning your business around and I will give you two months to come up with it." If it is granted, it is called a debtor-in-possession or Chapter 11 bankruptcy. The old management is allowed to stay and work out their problems.

When the plan that is filed makes sense, the judge usually approves it, even over strenuous objections of the creditors unless something very unusual has occurred in the interim such as fraud or perjury. The reorganization plan is more or less a business plan consisting of a number of facets, what is the debtor going to do differently than when he got himself in trouble?

What is he going to use for money in the meantime? Who is going to look over the situation to make sure that he doesn't fritter away whatever new money he receives as well as the last of the creditor's assets?

Without additional funding, there will be no money to pay the ongoing bills even though some of the old ones have been put on hold by the court. The court has an interesting mechanism to address that problem. It is called "debtor-in-possession certificates or "DIP". Under DIP financing, the debtor can go out and raise money that will come ahead of almost everything that was previously owed. It is a protection that is offered the new investors as an incentive for helping the company or individual out. Additionally, if the bankruptcy judge approves a DIP financing plan, an issues an order stating that position, the debtor does not have to clear the financing with the Securities and Exchange Commission which would normally be the case. DIP financing is exempt for the most part from securities laws.

So, it seems that the creditors are estopped from collecting the money owed them, the debtor is not paying anywhere near the bills he was paying before and he is still running his own affairs. Not a bad situation. In 1996, more than 1.1 million people in the United States thought so too and filed for bankruptcy. This is an increase of over 400% in just under two decades. Visa, the credit card people estimated that in that same year, more than \$30 billion was erased from the books of creditors by individuals filing for bankruptcy. For many years, the stigma of such a filing was emotionally so distasteful to people that they didn't try to file for bankruptcy and reorganize themselves or their businesses. As times have changed this has become an acceptable action, and debtors are no longer looked upon as pariah's in their communities when using the provisions of the code for this purpose.

Most recently, some have questioned whether or not the law hasn't become too lenient. Others indicate that they believe that the system has become abused and as a result Congress is revisiting the entire code with an eye towards making wholesale changes. There can be no question that certain people will take advantage of the system wherever and whenever they can.

Credit cards have become the abuse of choice. Individuals can run up enormous credit card debt, thanks to the careless issuance of the cards to any and all comers, live the good life for a period and then file for bankruptcy. Adding insult to injury are the state laws that effectively palliate the Federal Regulations with various homestead exemption. If you owned a large home with a lot of land, for example, you would probably want to file your bankruptcy action in Florida or Texas, which gives their citizens massive exemptions for this type of asset. Other states provide other types of relief that may be equally advantageous depending upon the filler's individual situation.

Individuals can also make use of the provisions of Chapter 13 of the code which allows them breathing room. It gives the debtor between three and five years to repay their outstanding debts without the fear of being harassed by creditors. Although there are major differences, Chapter 11 and 13 are similar in the respect that they both give the debtor time to regain his composure and address financial problems without being besieged by angry creditors demanding payment at all hours of the night.

The sophistication behind the use of the code has attained a level where some attorneys have figured out the advantageous of a tiered type of filing where they attempt to squeeze the regulation to the limit. They have come up with what is now referred to as a Chapter 20 filing. That is, a Chapter 13 followed by a Chapter 7. In certain very specific instances this can become a literally killing combination when used against creditors to the degree that it is almost abusive in its result.

A change in the regulations has been proposed called the "Responsible Protection Bankruptcy Act is moving slowly through Congress. It is more need generated than the existing code. It would look at who you support, what your costs are and then evaluate your needs. The Court would then adjudicate what assets you could keep and use the rest for distribution to creditors. One the reasons for the Bill has been the observation on the part of Bureaucrats and creditors that many of those taking protection under the codes have income-to-debt ratios that would have allowed payment of substantially all of their debt if it were not for the protection the law allows. Ultimately, what the act anticipates would be the closing of the door to Chapter 7 in certain cases where cash flow could eventually eliminate the indebtedness over time. These folks in order to receive relief would have to file only under Chapter 13.

This proposed regulation entitled the "McCullum-Boucher bill also envisions making the state regulations more uniform. Of course by doing this, the protected limits will become higher in many states, potentially leading to increased numbers of bankruptcy filings in those areas.

In the filing, the company or individual must list all of their assets. If it is pointed out during the court hearing that anything contained within the papers submitted by the debtor are untrue, the court has several options. It can do nothing under the

guise of it being a mistake. It can deny the debtor's discharge, which is a fate worse than debt; imagine being hounded day and night by angry creditors with literally no place to hide and no protection under the law. The court can undo any conveyances that it deems illegal if the intent of that conveyance was to injure creditors by making their money disappear. It can also bring criminal perjury charges against the debtor which could make him subject to fines and incarceration.

Bankruptcy fraud is very hard to prove, but severe penalties have been the rule rather than the exception in other times. The English Parliament authorized the death penalty for fraudulent bankruptcy filings in 1705. In the United States today, bankruptcy crimes carry a maximum of five years in jail or \$250,000 or both. Because of what is believe to be an increase in fraudulent filings, the National Bankruptcy Review Commission has recommended that petitions be subject to possible audits of the information that they contain. Limiting the number of filings that can be initiated by any one entity and setting up a national computer system to check on simultaneous filings in several states by one entity. Equally as bad is the practice of refiling bankruptcy in another state before the statute has run. In the case of individuals, certainly the heightened divorce rates and the dramatic increase in legalized gambling have caused people major financial grief. The outlook for the future is not too bright in our crystal ball and we envision only more of the same.

Bankruptcy is an industry that has its own camp followers, who are not a considered a group that one would want to have for diner. They are called "duckers and divers", and they represent themselves as experts in the affairs of bankruptcy and how helpful their knowledge would be in "working out" the company's problems. They seek out company's in distress and present themselves when business is at its lowest ebb. Management, feeling depressed over their state of affairs is desirous of being "saved" that even control in the company is turned over. These people sell assets away from court supervision and pocket the money, leaving management hold and even bigger bag.

We view reorganization as a legitimate business tool that can be used very effectively when all else fails. It is much more sophisticated than can be discussed within the framework of these few pages, but its nuances can make the differences between the success and failure of a business. In the right situations, we would be able to provide financial and managerial assistance to Chapter 11, debtor-in-possession filings. Our staff believes that this has been an underutilized option because the source of financing is not readily available when it comes time to propose a plan. Let us take a look at your situation and see if we can help.