Filing Chapter 11 without filing Chapter 11

Give your financially underperforming organization a second chance by embarking upon an out-of-court workout using a creditors' moratorium process.

America is the land of the second chance. Accordingly, our bankruptcy code includes what is known as Chapter 11. This is a legal mechanism whereby a company (debtor) that is insolvent or otherwise in financial difficulty can file a 'Chapter 11' proceeding with the court. The court will immediately impose an 'automatic stay', which creates a temporary bar preventing creditors from pursuing the debtor for the amounts owed. Not only does the stay freeze the creditors' claims; it also puts all unsecured creditors on a level playing field and into one basket, so that one creditor can't do things like seize the debtor's assets, thereby giving himself an advantage over other creditors.

For a debtor in trouble, the automatic stay is, at least in theory, a godsend, because it not only stops individual creditors from seeking an advantage over their fellow creditors; it stops the creditors from even contacting the debtor (after filing, now the DIP – Debtor in possession). The automatic stay thus creates breathing room for the debtor to think about and plan how he would like to reorganize his business and obtain additional financing, so that at some point in the future the debtor can emerge from Chapter 11 and resume busines operations profitably. In other words, it gives the debtor a second chance.

Chapter 11, at least for smaller debtors, is not quite the 'white knight rescuing the damsel in distress' that it might appear to be. It has significant problems; first, it is expensive (an important consideration especially because the debtor is usually already starved for cash). The debtor has to hire bankruptcy counsel, and pay their retainer. Their retainer can often be very significant because once they file on behalf of the debtor, they can't be paid further amounts without a fee hearing (i.e. court approval), and judges tend to defer fee hearings, because they find them tedious, for as long as possible (this is one of the reasons why many law firms refuse to practice bankruptcy law). There are also court filing fees. Periodic reports have to be filed with the court. Second, Chapter 11 can be very inflexible, because to take actions the debtor must first file a motion with the court with all the normal notice periods and then have a hearing. Third, before the debtor can emerge from bankruptcy, or make a distribution to creditors, he must pay all his legal fees. Often the legal fees are so prohibitive that the debtor cannot successfully emerge from Chapter.

The biggest impediment to Chapter 11 is human nature. That is, the debtor usually waits until the eleventh hour before deciding to file. Then he finds out that Chapter 11 is actually not a practical option because he can't afford the funds required to move forward with the filing. Some would say America's promise of a second chance, when you get right down to it, turns out to be somewhat hollow.

When a debtor finds himself in this predicament, he does have an alternative to liquidation, at least in California (and some other States). It is a little-known process called an "**out-of-court creditors' moratorium**". It is 'little known' even amongst bankruptcy attorneys because (a) it can be executed effectively while keeping legal fees very low (read 'it doesn't make much money for attorneys' and is therefore not popular, so your attorney is unlikely to provide you with this option); and (b) it is somewhat more complicated than a conventional Chapter 11 filing.

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How does an out-of-court creditors' moratorium process work? Is it as effective as a Chapter 11 filing? Does it give the debtor a better chance of emerging at a future point in time and resuming operations profitably, than Chapter 11?

The Creditors' moratorium process mirrors Chapter 11 in most ways. That is, in Chapter 11 the court acts as the Trustee and the automatic stay goes into effect on the filing date. In a Creditors' moratorium process, the CMA (Credit Managers Association) acts as the Trustee. The CMA notifies creditors, establishes a moratorium date (the equivalent of the automatic stay date in Chapter), and the amount owed to each unsecured creditor on that date, and calls a creditors meeting. At the creditors meeting, usually held at the CMA's offices, the debtor's financials are presented and explained. Assuming the creditors agree to go forward with the creditors' moratorium process, the creditors vote to form a creditors' committee, and the creditors' and debtor's attorneys are introduced. This, unlike a Chapter proceeding, is all done on a consensual basis. The creditors agree not to pursue the amounts they are owed on the moratorium date. The creditors' committee agrees to hold meetings, usually monthly, which are attended by the committee, the debtor's and creditors' attorneys, and the debtor provides updated financials and a progress report.

What happens if an unsecured creditor decides he doesn't want to participate in the moratorium? He decides to pursue his own efforts at recovering the amounts he is owed (there are usually one or two often less sophisticated creditors who decide to take this route).

When the moratorium is agreed to, the debtor gives the creditors a UCC security interest over all the assets of the debtor company, for the aggregate amount of the funds owed to the participating (previously unsecured) creditors. This security interest is recorded, and has the effect of transforming this previously unsecured creditor group into a secured creditor. Accordingly, any unsecured creditor who decides he doesn't want to participate in the moratorium is not covered by this security interest. This security interest by its nature gives the now secured creditor group an interest in the debtor's assets that has priority over the non-participating unsecured creditor. So if the unsecured creditor decides to litigate against the debtor, the CMA can file an intervening action asserting the superior nature of their now secured creditor group. In other words, this lien interest has the same effect as the automatic stay in a Chapter filing.

The CMA charges a fee to act as the Trustee in this process. And the two sets of attorneys also charge. All of these fees have to be paid by the debtor. The total amount of these fees, however, are usually several orders of magnitude lower than they would be in a Chapter proceeding.

Further, the process has considerably more flexibility. If the debtor wishes to pursue a particular course of action, he contacts his attorney, who in turn contacts the creditor's committee attorney, and a decision is made. This can usually be done quite quickly, and avoids a lot of the time and expense involved were this to be attempted in a Chapter proceeding.

Another thing that is often done in a Creditors' moratorium is that all of the creditors are grouped by the debtor into creditors that are 'ongoing' i.e. they continue to do business with the debtor, albeit on a COD basis, and those that are 'one-time' creditors i.e. they have no ongoing business with the debtor. It behooves the debtor, after making this analysis, to encourage the Creditors' Committee to be composed solely of creditors in the 'ongoing' category.

Additionally, often in a creditor's moratorium process, all of the small creditors e.g. creditors owed $5,000 or less, will be grouped together and the Creditors' Committee will agree to allow the debtor to pay them off early, or even immediately. This is usually a prudent thing to do because it leaves the debtor with only larger creditors, and they tend to be companies that have more financial sophistication. They understand the moratorium process and agree with it, whereas the smaller creditors tend to be less sophisticated.

The creditors' moratorium process does have some limitations. When a debtor files Chapter 11, all of the debtor's executory contracts become voidable ('voidable' means that the debtor gets to decide whether to affirm or reject the contract). Executory contracts include union contracts, equipment leases, development contracts, licenses of intellectual property and real estate leases, among others. This 'voidability' is not available in a creditors' moratorium situation.

The CMA has in the past few years withdrawn from participating in the creditors' moratorium process. The Trustee in a creditors' moratorium process, however, does not have to be the CMA. One could easily appoint a law firm with a good reputation to perform this Trustee function, though they'd have to be educated in how to handle this process. Additionally, there are other companies and individuals who have in depth experience in acting as Trustee in a creditors' moratorium situation. Should a debtor be considering a creditors' moratorium, it is important to use attorneys who have experience with the process. It's also important that the debtor have someone, usually their CFO or CEO, who understands the process and can help the debtor navigate through the process. I have shepherded many debtors, as their CFO, through this process successfully. I understand it; I like the process because, unlike a Chapter proceeding, it allows the debtor to retain much of its capital and put it toward turning around the company's operations, rather than paying it to attorneys. I also know many of the attorneys in California who are familiar with this process.

It should be mentioned that the 2020 CARES Act changed some of the calculus above in several ways. Specifically, the CARES Act introduced a new SubChapter 5 to the Bankruptcy code. SubChapter 5 is designed to streamline the Chapter 11 process for small debtors, and to make it faster and less expensive. SubChapter 5 is designed for debtors with a total of less than $2.7M in total debt. With the pandemic upon us, this limit was increased for 1 year to $7.5M, after which it is slated to revert to $2.7M. It is a bit early to tell how effective SubChapter 5 will be; the courts and attorneys are still all involved. However, it is probably safe to say that, at least in theory, SubChapter 5 is a move in the right direction.

SubChapter 5 does have a couple of very interesting features that will be very attractive to the right debtor. For example, if an individual business owner has loaned money to his business, and secured his home to obtain that money, the court in a SubChapter 5 proceeding has the right to modify that loan.

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