

IF YOU HAVE QUESTIONS REGARDING THIS MATTER, PLEASE CONTACT:



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PRE-BANKRUPTCY BASICS

Physician groups, physician practice managers, suppliers, entrepreneurs who contract with health care providers and sometimes even hospitals contemplate filing for bankruptcy protection from creditors when their reimbursement does not meet the obligations they have assumed in providing services. This week, Billy Leonard, the department chair of Strasburger's bankruptcy practice, covers the general issues which need to be addressed in determining whether initiating a Chapter 11 a bankruptcy is an advisable business strategy.

Businesses seeking bankruptcy protection have a choice of either commencing a Chapter 7 bankruptcy proceeding, which is a liquidation, or a Chapter 11 proceeding, which is a reorganization. Under a Chapter 7, the business closes its doors, a trustee is appointed, and the assets of the business, if any, are collected, converted to cash, and then distributed to the creditors of the debtor in accordance with bankruptcy priorities. This article, however, focuses on a Chapter 11 proceeding, where management of the business hopes to reorganize its financial affairs and continue its business. The primary benefit of a Chapter 11 proceeding is that the Bankruptcy Code permits the debtor, in most circumstances, to remain in control, conduct its business, and provide a breather from the collection efforts of its prepetition creditors in order to give the debtor time to propose and garner approval of a plan of reorganization.

Cash is King

It is important to understand that bankruptcy is a difficult process. One of the largest hurdles to overcome is lack of working capital. In order to have a successful reorganization, the debtor needs unencumbered cash or a lending source willing to extend a post-petition, debtor in possession loan in amounts sufficient to enable the debtor to fund its postpetition operations. Without cash, it is very difficult to survive the bankruptcy. The debtor must anticipate that vendors will refuse to deliver goods and/or services (absent a contractual obligation to do so) unless they are paid in advance. This presents a tremendous demand on cash and is something that the debtor will need to address with its vendors. Ideally, a company can negotiate credit terms with suppliers and/or vendors, albeit on not as favorable terms as it may have gotten pre-bankruptcy. Dealing with vendors who demand cash in advance, the prospect of laying off employees, facing the uncertainty in the work environment created by the bankruptcy filing, and having company business records, practices, and transactions completely exposed to creditors and the courts are a few of the items executives find stressful in the bankruptcy process.

Business Plan/Exit Strategy

In addition to the need for cash, a company contemplating bankruptcy needs a business plan and/or exit strategy. Most successful Chapter 11 reorganizations occur through the negotiation process. In other words, negotiating with the various constituencies to formulate a reorganization plan that is acceptable to the creditors is much more likely to be successful than trying to force or "cram down" a plan. In order to have a successful reorganization proceeding, it is extremely important for the prospective debtor to have a defined business plan/bankruptcy exit strategy before commencing the bankruptcy. There is a variety of strategies for a debtor's business plan/exit strategy. The plan may be to restructure debt to levels that can be repaid through existing operations, bring in new investors to infuse working capital in exchange for ownership in the reorganized debtor,

cancel existing equity and issue stock to the creditors, or propose a liquidating plan where the assets are sold and the funds distributed to creditors pursuant to bankruptcy priorities and the terms of the plan. The important aspect at this stage of the process, however, is to have a plan—some idea of how the company will exit the bankruptcy process.

There are many requirements a company must fulfill as part of its plan for reorganization. A plan, in effect, is a court approved contract with the company's prepetition creditors regarding repayment of debt. As a general rule, the debtor must file a plan within 120 days of filing the bankruptcy petition. The debtor then has 60 days to get the plan approved. These deadlines can be extended; however, in light of recent Bankruptcy Code amendments and trends in bankruptcy court decisions, extensions of the deadlines to file plans of reorganization are more difficult to obtain. If the debtor fails to propose a plan within the 120 day period, and does not receive an extension through a court order, then anyone may propose a plan on behalf of the debtor.

Commencing the Bankruptcy and First Day Hearings

A Chapter 11 reorganization proceeding is commenced by filing a bankruptcy petition. The petition is generally a two or three page document, and does not take long to prepare. It requires corporate or entity authorization for it to be filed. Generally, business entities that have a domicile, place of business, or property in the United States may be a debtor under the Bankruptcy Code. Corporations, partnerships, limited liability companies, and individuals are all included as eligible debtors. At a minimum, to commence a Chapter 11, the debtor needs the petition, the filing fee of \$1,039, a mailing matrix (listing of names and addresses of all creditors), a disclosure of compensation to debtor's attorneys, and a list of the top twenty unsecured creditors. A debtor also has the option to file the Statement of Financial Affairs, the Summary of the Schedules, and the Schedules of the Debtor along with the petition. The Statement of Financial Affairs and the Schedules, if not filed with the petition, must be filed within 15 days of the filing of the bankruptcy proceeding. The Statement and Schedules contain detailed financial information about the debtor, list material transactions that have occurred pre-bankruptcy, and list all creditors and the amounts owed. Unlike the petition, the Schedules and the Statement take much client and attorney time to prepare. Further, these documents must be accurate. Ideally, the company should prepare the statement and schedules prior to filing the bankruptcy proceeding. Otherwise, valuable time of executives of the debtor will be used to prepare these documents during the first 15 days of the bankruptcy proceeding.

Since cash and the use of cash are critical to the survival of the debtor, debtors who have had some lead time to prepare for the bankruptcy will often seek to have first day hearings on critical matters. Unless the debtor has sufficient unencumbered cash to fund its needs, the most critical of these "first day motions" are those seeking authority to use cash collateral and authority to enter into postpetition financing.

If the debtor has a source of funding for its post bankruptcy operations, the terms of the loan must be approved by the court. These loans are commonly referred to as debtor in possession (DIP) financing. There are guidelines on what can and cannot be included in DIP financing agreements and orders approving DIP loans. Because of the expedited nature of the first day hearing on approval of DIP financing, the initial approval by the court is generally on an interim basis with a final hearing to be scheduled approximately 20 days later to obtain final approval.

This gives creditors an opportunity to review the DIP financing terms and, if necessary, to object to them.

In addition to (or sometimes in conjunction with) DIP financing, a debtor will need to get permission to use cash collateral. Cash collateral is generally cash or cash equivalents (receivables) that are burdened by a third party lien. In order to use such cash/receivables in bankruptcy, the debtor must have the permission of the lien holders. Since most debtors have a need for cash, a motion to use cash collateral is something generally a debtor files immediately upon the commencement of the bankruptcy and is taken up as a "first day motion." In order for a debtor to obtain authority to use cash collateral (and to obtain DIP financing), the courts will require the debtor to present an operating budget and to use cash only to the extent provided for in the approved budget. Naturally, by preparing and using a budget to obtain use of cash collateral and/or authority to obtain DIP financing, the debtor is setting performance standards for it to meet. Failure to meet these standards can present reliability problems when proposing a budget for the plan of reorganization confirmation process.

Since having cash available to fund operations and having a business plan or exit strategy in place at the time of the commencement of the bankruptcy proceeding are critical to the reorganization process, the more time a company's management has to prepare and plan for the bankruptcy, the greater the likelihood that the company will have a successful reorganization.