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When a Chapter 11 Plan is Absolutely Dead on Arrival

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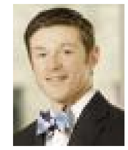

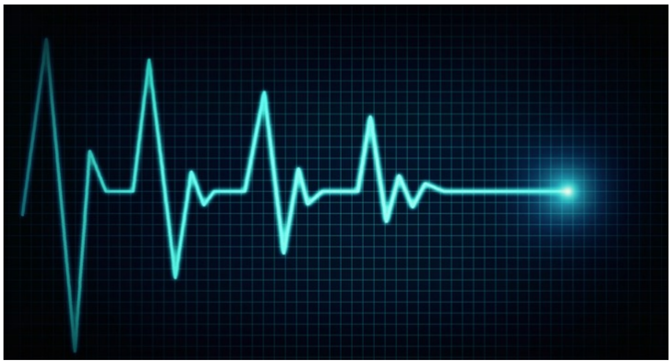

Recently, we discussed In re CHL, a case involving a real estate developer in Chapter 11.

We focused on the importance of the Disclosure Statement as a prerequisite to a debtor's ability to move forward with a plan of reorganization. In a Chapter 11 bankruptcy, the debtor attempts to reorganize its affairs through a Chapter 11 Plan. When the debtor files its proposed Plan, it must also file a Disclosure Statement providing creditors and claimants with "adequate information" about the Plan. Creditors rely on the Disclosure Statement to learn how, and what amount, the debtor will re-pay them under the Plan, and what risks they will face under the Plan. Armed with this information, creditors and claimants can support or oppose the Plan, and the Court can determine if the debtor may proceed to a confirmation hearing.

In In re CHL, the debtor's primary operations involved developing property in a multi-phase subdivision called Scotts Hill Village in Wilmington, North Carolina. The debtor owned 52 developed lots and 57 acres of undeveloped land when it filed for bankruptcy. The Plan proposed to sell the lots in phases to a residential builder and develop the property over time, generating the revenue necessary to pay creditors.

In addition to the Court's recitation of the "adequate information" required in a Disclosure Statement, the decision illustrates another important aspect of Chapter 11 – debtors should not file Plans that are dead on arrival. If the Court determines from the jump that a Chapter 11 Plan cannot be confirmed, then it must decline approval of the Disclosure Statement and halt the confirmation process. In other words, if the proposed terms make clear that the Plan can't succeed, the Court will step in to prevent a costly and time-consuming confirmation process. A confirmation hearing can be as involved as a civil trial – lasting several days and involving multiple fact and expert witnesses. Consequently, the Court will not allow the Debtor to waste the time of the Court and creditors in pursuit of a futile Plan.

Under the Bankruptcy Code, a Plan must be "fair and equitable" to creditors opposing the Plan. The "fair and equitable" requirement is expansive and embodies many aspects of a proposed plan. In In re CHL, the Court homed in on one aspect of the Plan that was not fair and equitable. Under the Plan, Ernest Woodrow Davis Jr., the Debtor's principal, intended to retain his 100% interest in the debtor company. Mr. Davis intended to retain his equity ownership, but the Plan did not intend to pay the creditors in full.

This provision violated the Absolute Priority Rule. The Absolute Priority Rule is a cardinal principle of bankruptcy law that provides foundational protection for creditors. In general terms, it requires senior classes of creditors to be provided for in full before a junior class can receive a distribution under a chapter 11 plan. Under the Rule, if a debtor cannot pay its creditors in full, then the owners cannot retain their interests in the company unless they contribute new value to the business that is substantial and essential to the company's reorganization efforts. Mr. Davis offered no "new value" under his Plan, so on its face it violated the Absolute Priority Rule.

Creditors and claimants in Chapter 11 proceedings should scrutinize a debtor's initial Disclosure Statement and Plan of Reorganization. For if the proposed Plan is unconfirmable on its face, the Court will require the debtor to amend the Plan to repair the fatal defect or stop the confirmation process entirely.

Ward and Smith represented the lead creditor in this case.

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