



## Reorganizations – Advantages, Pitfalls and Your Role (2 pt. session)

2:45pm-3:45pm

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## Practice Focus

Glenn D. Solomon is a Principal in the firm's Business & Real Estate Group and head of the firm's Insolvency, Reorganization and Creditor's Rights Practice Area. In addition, Mr. Solomon has extensive experience in business transactions and issues of concern to businesses and business owners, including mergers and acquisitions, trademarks, employee benefits, bankruptcy preference actions, estate planning, mortgage lending, and sports law. In addition, Mr. Solomon earned his Certified Public Accountant license in 1984.

## Education

J.D. (with honors), University of Maryland, 1984  
B.A., Franklin and Marshall College, 1981

## Bar and Court Admissions

Maryland

## Activities

Mr. Solomon actively served as Vice President and Director of the Greater Baltimore unit of the American Cancer Society and as President and Director of the Liberty Showcase Theater. Mr. Solomon currently serves as Vice President and on the Executive Committee and Board of Directors of the Jewish Federation of Howard County.

## Publications/Speeches

Mr. Solomon has been a frequent publisher and lecturer on various legal issues relating to distressed companies and employee benefits.

**REORGANIZATIONS -  
ADVANTAGES, PITFALLS AND YOUR ROLE**

by

Glenn D. Solomon

**INTRODUCTION**

Your client is in peril. Should your client file for Chapter 11? This presentation will discuss the benefits and disadvantages of a Chapter 11 reorganization case, how it works and how you fit in.

You can have an important role in helping your client understand its alternatives and survive the hard times.

Insolvency planning and implementation require substantial budgeting, financial analysis and financial reporting.

**FIRST THINGS FIRST**

Client must be able to pay its ongoing operating expenses with current cash flow.

Steps:

1. Reduce Expenses
2. Obtain Financing
3. Increase Revenues

**Your Role:** Assist your client to determine what expenses to cut and to formulate a new budget. If your client has cut expenses as much as it can, is unable to obtain financing and

does not have sufficient cash to pay ongoing expenses, your client should stop. Chapter 11 reorganization is not for your client, and other alternatives should be considered. If, however, your client can generate sufficient cash flow to pay ongoing expenses, Chapter 11 should be explored.

### **ADVANTAGES**

#### 1. Time to Reorganize.

- In general, upon the filing of a Chapter 11 bankruptcy case, creditors are prohibited from instituting or continuing litigation against your client.

- A debtor has the exclusive right to file a plan of reorganization during the first 120 days after the case is filed. The 120-day period may be extended for up to 18 months after the case is filed. In a typical Chapter 11 case, a plan would be filed sometime after 180 days and prior to 18 months after the case is filed. (If a company is a "small business," the dates to file a plan of reorganization change somewhat. A small business is a company, including its affiliates, that has debts in an amount less than \$2,190,000.00, excluding amounts owed to affiliates and related parties, such as owners, directors and officers).

2. Rejection of Contracts.

- Your client may be burdened by an above-market lease, a prohibitively expensive supply agreement or a costly union contract.

- A debtor is permitted to terminate, or "reject", existing leases and contracts that the debtor believes are cumbersome.

- The debtor has the unilateral right to reject the contracts.

- Any creditor whose contract is rejected would have a claim for damages that would be deemed to exist on the day before the bankruptcy case is filed.

3. Assumption of Leases.

- A debtor can continue with existing leases as long as payments are current or there are adequate plans to become current.

4. Debt Reduction.

- There is a possibility in a Chapter 11 case that your client's overall liabilities can be reduced, that is, that the client could obtain approval of a plan that provides for the payment of less than 100% of its liabilities that existed at the time the case was filed.

- Factors - Your client's financial wherewithal at the time the plan is filed; whether creditors object to the plan.

## **PITFALLS**

1. Costs. The costs of a Chapter 11 case can be staggering:

- Legal fees, which can range from \$25,000 in a very small case to millions of dollars in a very large case, depending upon the complexity of the case (legal fees of debtor, secured creditors, unsecured creditors committee)

- Quarterly fees to the Office of the United States Trustee, the government agency that oversees Chapter 11 cases

- Accounting fees

- Appraisal fees

- Intangible costs - substantial amounts of time must be devoted by your client's management.

2. Negative Publicity.

- Chapter 11 filings are public record;

- Vendors may require your client to begin doing business on a C.O.D. basis, if that had not already occurred. This is not set in stone. If a company has a long standing, and good standing, relationship with its vendors, certain vendors may continue doing business with the company based upon the

credit terms that existed prior to the filing of the Chapter 11 case.

3. Reporting and Administrative Requirements.

- Monthly operating reports must be filed with the court, and consist of a balance sheet, an income statement, bank statement reconciliations and a questionnaire. If your client has the internal resources, the monthly operating report may be prepared by the client. If not, the client will need your assistance to prepare the reports.

- The company must close all existing bank accounts and establish new "debtor-in-possession" bank accounts at an approved bank. Balances in existing bank accounts must be physically transferred to the new debtor in possession accounts.

- New insurance certificates naming the insured as "debtor in possession" must be obtained.

4. Greater Oversight of Transactions. Although a company is entitled to continue to operate in the ordinary course of business in a Chapter 11 case, there will be greater oversight of transactions engaged in by the company and of its operations.

- The Office of the United States Trustee will monitor your client's Chapter 11 case.

- Unsecured creditors can form a committee which also monitors the case and the company's operations.

- Transactions between the company and its affiliates, owners and officers prior to the bankruptcy filing, such as loan repayments and increases in compensation, will be examined to determine if they were ordinary. If there were unordinary transactions engaged in, the third party receiving the benefit of the transaction could be required to return the benefit.

- Certain transactions will require the approval of the court (sale of business, refinance, new loans)

5. Loss of Ownership. It is possible that the owners of a company filing Chapter 11 would not be able to retain part or all of their ownership in the company.

- One of the requirements of a Chapter 11 plan is that objecting creditors receive 100% of the amount owed plus interest over time. If that plan requirement is not satisfied, then, owners, who are deemed to be junior in priority of payment to creditors, may not retain their ownership

- "New value" exception - cash or other property contributed to the company by the owners equal to at least the fair market value of the company at the time that the plan of reorganization is filed.

6. Lenders. If your client has financing in place, it must obtain permission from its lenders to use its cash at the outset of the bankruptcy case and continuing during the case.

Typically, an agreement providing for the use of cash is made with lenders prior to or at the time of filing the bankruptcy case.

## **THE REORGANIZATION PLAN**

### 1. Voting.

- Each class of creditors must either be paid in full, with interest, or have accepted the plan. (There is an exception if at least one class of creditors approves the plan, and the court determines that the plan is fair to all classes of creditors.)

- A class of creditors accepts a plan when creditors representing two-thirds of the total dollar amount of the claims in that class and one-half of the total number of claims in that class vote to approve the plan.

### 2. Payments to Creditors.

- If a class of creditors has not accepted a Chapter 11 plan, then the plan must provide for the payment of 100% of the claims plus interest, or the owners of the company must contribute new value.

- Included among the claims that must be paid are the claims held by creditors whose contracts or leases have been rejected. The amount of the creditor's claim will generally

equal the profits the creditor would have received had the contract or lease not been terminated.

**Your Role** - Your client will need your assistance to evaluate the amount of the creditor's claim.

- The debtor must pay to all creditors over time at least as much as the creditors would receive as if the assets of the company were liquidated. A debtor typically engages an appraiser to determine the liquidation value of the debtor's assets. You may have a role in that appraisal.

- The payments under a Chapter 11 plan are generally made for a period of five years or less.

3. Effect of Approved Plan.

- Discharge of debt
- Permanent cessation of lawsuits pending at the time the case was filed
- Continuation of assumed contracts and leases

**TAX ISSUES**

1. Discharge. Does not result in gross income. Exclusion is limited to the amount of the debtor's insolvency.

- The exclusion of income from the discharge of debt reduces tax attributes, including (1) net operating losses for the year of discharge and the net operating loss carryover to the year of discharge, (2) net capital losses for the year of

discharge and net capital loss carryovers to the year of discharge, and (3) the basis of property.

2. NOL Carry Forwards. NOL carry forwards continue to be available (unless reduced by discharge of debt income or if there is a substantial change of ownership).

3. Tax Compliance. The filing of a bankruptcy has no impact on the debtor's duty to file tax returns; however, prepetition taxes cannot be paid until there is court approval - postpetition taxes must be kept current.

4. Tax Refunds. The debtor may or may not be entitled to receive tax refunds as a result of losses, depending upon the year of the loss.

## **CONCLUSION**

Your clients in financial peril need your help. They arrived where they are because of a combination of one or more of the following: unrealistic optimism, poor planning, overspending and a bad economy. You can help them determine whether Chapter 11 is viable and if it is, help them navigate through its muddy waters.

Glenn D. Solomon is chairman of the Insolvency and Creditor's Rights Department of Offit Kurman, P.A., a regional law firm

with offices in Philadelphia and throughout Maryland. Mr. Solomon can be contacted at [gsolomon@offitkurman.com](mailto:gsolomon@offitkurman.com).