

The Effect of Ongoing Civil Litigation on Chapter 11 Reorganization

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Introduction

Businesses and, in some cases, individuals who have incurred a significant amount of debt can voluntarily file for bankruptcy under chapter 11 of the Bankruptcy Code as a means of settling their debts with their creditors and preserving their businesses as going concerns. Chapter 11 is a vehicle for businesses to achieve this goal because it emphasizes debtor reorganization and rehabilitation rather than liquidation.¹ Chapter 11 strikes a balance between rehabilitating the debtor and maximizing value to creditors.² Public policy encourages reorganization as opposed to liquidation wherever possible because the successful rehabilitation of debtors is in the best interest of creditors and the economy.³

¹ *Liberty Mut. Ins. Co. v. Holloway (In re Liberty Mutual)*, 2010 WL 3735783, n. 6 (S.D. Miss. Sept. 20, 2010) (“Chapter 11 bankruptcy proceedings ordinarily are brought by a debtor in possession and culminate in the confirmation of a plan of debt reorganization rather than liquidation.”); *Florida Dep’t of Revenue v. Piccadilly Cafeterias, Inc. (In re Piccadilly)*, 554 U.S. 33, 37, 128 S. Ct. 2326, 2330-31, 171 L. Ed. 2d 203 (2008) (holding chapter 11 does contemplate possibility of liquidation, but is different from chapter 7 which focuses primarily on liquidation.)

² *In re Philadelphia Newspapers, LLC, et al.*, 599 F.3d 298, 303 (3d Cir. 2010).

³ *In re Antelope Technologies, Inc.*, 2010 WL 2901017 at *4 (S.D. Tex. July 21, 2010) (“[T]he purpose of Chapter 11 of the Bankruptcy Code is to assist financially distressed businesses by providing breathing space to reorganize.”); *In re Sandy Ridge Dev. Corp.*, 881 F.2d 1346, 1352 (5th Cir.1989) (“[A]lthough Chapter 11 is titled ‘Reorganization,’ a plan may result in the liquidation of the debtor.”).

Consequently, the role of bankruptcy courts in chapter 11 cases is to determine whether the proposed reorganization or liquidation has a legitimate possibility of being successful.⁴ Among other things, section 1129 of the Bankruptcy Code outlines the factors courts consider when determining whether it is reasonable to expect that a debtor will be able successfully consummate its proposed plan of reorganization or liquidation.⁵ A court might determine that a debtor's plan is not feasible for a variety of reasons. For example, in chapter 11 cases that involve numerous creditors it is common for there to be non-bankruptcy litigation between a debtor and its creditors or other parties-in-interest. In such a situation, the bankruptcy court may determine that a plan is not feasible for the debtor due to concerns about what effect the outcome of such pending litigation may have on the debtor's current state of affairs.

For example, the Bankruptcy Appellate Panel of the Ninth Circuit Court of Appeals recently considered this very issue, and its impact on chapter 11 plan confirmation, in *In re RCS Capital Development*.⁶ There, the court held that in certain situations, a debtor's plan can be feasible even if the debtor is involved in ongoing civil litigation.⁷ This Article will discuss Section 1129 of the Bankruptcy Code which codifies what is required for confirmation of a chapter 11 reorganization plan. Part I will analyze the relevant provisions of Section 1129. Part II will take a closer look at the requirement that a chapter 11 plan be feasible. Finally, Part III will analyze the effect ongoing civil litigation has on chapter 11 plan feasibility.

I. Chapter 11 Plan Confirmation Requirements

Chapter 11 is designed to allow for the reorganization of a financially distressed business enterprise with the goal of providing for the rehabilitation of such enterprise by adjusting its debt

⁴ 11 U.S.C. § 1129 (2012).

⁵ *Id.*

⁶ *In re RCS Capital Dev., LLC*, AZ-12-1626, 2013 WL 3619172 (B.A.P. 9th Cir. July 16, 2013).

⁷ *Id.* at *8.

obligations and equity interests,⁸ thereby simultaneously reviving the business, and protecting creditors and other stake-holders.⁹ Alternatively, chapter 11 also allows for a debtor to liquidate, often through post-confirmation trusts, in order to maximize value for creditors and other stakeholders.¹⁰ The plan of reorganization or liquidation itself is the spine which supports such restructuring or liquidation. While there are no outer limits to the possibilities of provisions which can be included in a chapter 11 plan, the plan must at a minimum meet the requirements set forth in Section 1129(a) of the Bankruptcy Code.¹¹

There are thirteen requirements every reorganization plan must satisfy in order to be confirmed.¹² The bankruptcy court evaluates each plan to determine whether the requirements set forth in 1129(a) are met, and the court will confirm a debtor's plan only if all requirements are satisfied.¹³ Although all thirteen requirements in section 1129 must be satisfied to confirm a chapter 11 plan, the discussion in this article will scratch only the surface of several of these requirements while only giving an in depth analysis of the feasibility requirement.¹⁴

The general requirements of the Bankruptcy Code are that (1) the plan must comply with the applicable provisions of the Bankruptcy Code,¹⁵ (2) the proponent of the plan must comply with the applicable provisions of the Bankruptcy Code,¹⁶ and (3) the plan must have been

⁸ S. REP. 95-989, 95th Cong. 2d Sess 9 (1978).

⁹ *Toibb v. Radloff* (*In re Toibb*), 501 U.S. 157, 163, 111 S. Ct. 2197, 2201, 115 L. Ed. 2d 145 (1991) (explaining Congress' purpose of Chapter 11 was business debtors reorganization to revive business, preserve jobs and protect investors.)

¹⁰ Jeffrey Ayres, *Liquidating Trust Structure Is Key to Maximizing Payouts*, J. CORP. RENEWAL (Oct. 1, 2006), <https://www.turnaround.org/Publications/Articles.aspx?objectID=6590>.

¹¹ Richard M. Cieri & Barbara J. Oyer, Dorothy J. Birnbryer, "*The Long and Winding Road*": *The Standards to Confirm A Plan of Reorganization Under Chapter 11 of the Bankruptcy Code (Part I)*, 3 J. BANKR. L. & PRAC. 3, 4 (1993).

¹² 11 U.S.C. § 1129(a) (2012).

¹³ *Id.* § 1129(b); *In re Texaco Inc.*, 84 B.R. 893, 905 (Bankr. S.D.N.Y. 1988).

¹⁴ *In re Texaco Inc.*, 84 B.R. at 905 (Bankr. S.D.N.Y. 1988) ("In order for the Plan to be confirmed, it must satisfy each of the requirements imposed under Section 1129 of the Bankruptcy Code.")

¹⁵ 11 U.S.C. § 1129(a)(1).

¹⁶ *Id.* § 1129(a)(2).

proposed in good faith.¹⁷ The first and second requirements are set in place to ensure that a debtor’s plan complies with other sections of the Bankruptcy Code, namely sections 1122, 1123 and 1125.¹⁸ “Good faith,” however, neither defined in the Bankruptcy Code, nor are there any guidelines for this requirement in other provisions of the Bankruptcy Code; thus, there has been immense amount of litigation regarding the meaning of the term. Courts generally agree that the good faith must be examined in light of the totality of the circumstances surrounding the plan and its proposal.¹⁹

In some instances, the good faith requirement overlaps with section 1129(a)(11)’s feasibility requirement when the court examines whether the plan is likely to be successful.²⁰ For example, the court in *Matter of Sun Country Development, Inc.*, considered feasibility and determined that the corporation’s owner proposed the plan with the legitimate purpose of granting the corporation a fresh start and emphasized that because the plan had a reasonable possibility of succeeding, it satisfied the good faith requirement.²¹ Furthermore, the feasibility requirement is a crucial component of chapter 11 plan confirmation beyond the role it plays in determining whether a plan was proposed in good faith.

II. The Feasibility Requirement

Section 1129(a)(11) of the Bankruptcy Code requires that, in order to be confirmed, the debtor’s proposed plan must be “feasible.”²² According to the Bankruptcy Code, a plan is feasible when “[c]onfirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor or any successor to the debtor under the

¹⁷ *Id.* § 1129(a)(3).

¹⁸ *In re Texaco Inc.*, 84 B.R. at 905–07.

¹⁹ *In re TCI 2 Holdings, LLC*, 428 B.R. 117, 142 (Bankr. D.N.J. 2010); *In re W.R. Grace & Co.*, 475 B.R. 34, 87 (D. Del. 2012); *Texas Extrusion Corp. v. Lockheed Corp.* (*In re Texas Extrusion Corp.*), 844 F.2d 1142, 1160 (5th Cir. 1988); *In re Stolrow's Inc.*, 84 B.R. 167, 172 (B.A.P. 9th Cir. 1988).

²⁰ 11 U.S.C. § 1129(a)(11).

²¹ 764 F.2d 406, 408 (5th Cir. 1985).

²² 11 U.S.C. § 1129(a)(11).

plan, unless such liquidation or reorganization is proposed in the plan.”²³ The feasibility requirement is an important safeguard for the central purpose of chapter 11; by mandating that that a court only confirm a plan which has a reasonable chance of success it becomes more likely that the chapter 11 debtor will emerge from bankruptcy as a viable entity or successfully liquidate in a manner that maximizes the value of the debtor’s estate.²⁴

In order to establish feasibility, the debtor need not guarantee the success of the plan.²⁵ Instead, the debtor must only establish that it can carry out the plan as a practical matter after confirmation,²⁶ and that it will be able to satisfy its financial obligations under the plan.²⁷ Although there is no exhaustive list of the factors the court may consider in its feasibility analysis,²⁸ the court will commonly consider “(1) the adequacy of the capital structure; (2) the earning power of the business; (3) economic conditions; (4) the ability of management; (5) the probability of the continuation of the same management; and (6) any other related matter which determines the prospects of a sufficiently successful operation to enable performance of the provisions of the plan.”²⁹ The court considers these factors in light of the objective facts of the case in order to determine the probability that the debtor will actually be able to carry out the proposed plan.

²³ *Id.*

²⁴ *See In re Union Fin. Servs. Grp., Inc.*, 303 B.R. 390, 427 (Bankr. E.D. Mo. 2003).

²⁵ *In re Nauman*, 213 B.R. 355, 358 (B.A.P. 9th Cir. 1997).

²⁶ *Clarkson v. Cooke Sales & Serv. Co. (In re Clarkson)*, 767 F.2d 417, 420 (8th Cir. 1985); *In re Nauman*, 213 B.R. at 358 (finding courts view the word “feasible” within its ordinary meaning that something is capable of being carried out).

²⁷ *In re Sagewood Manor Associates Ltd. P'ship*, 223 B.R. 756, 763 (Bankr. D. Nev. 1998) (“The inquiry is on the viability of the reorganized debtor, and its ability to meet its future obligations, both as provided for in the plan and as may be incurred in operations.”) (internal quotations omitted).

²⁸ *In re Drexel Burnham Lambert Grp., Inc.*, 138 B.R. 723, 763 (Bankr. S.D.N.Y. 1992).

²⁹ *In re Sagewood Manor Associates Ltd. P'ship*, 223 B.R. at 763 quoting *In re Lakeside Global II, Ltd.*, 116 B.R. 499, 506 (Bankr. S.D. Tex. 1989).

A chapter 11 plan must consist of more than visionary promises; a debtor must include evidence to reasonably satisfy the court that it will be able to carry the plan through to fruition.³⁰ If the court determines that a plan promises a creditor something that the debtor cannot realistically provide after confirmation, or that a subsequent liquidation is inevitable, then the court must refuse to confirm the plan as unfeasible.³¹ For example, in *In re Diplomat Construction, Inc.*, the debtor's plan relied on the projection that its hotel would sell for \$12,575,000.00, which the court considered to be grossly overestimated and unrealistic valuation of the hotel.³² As such, the court held that the plan was not feasible because the payments proposed in the plan were premised on the existence of funds that would not be available to the debtor, the debtor would probably be unable to make the payments under the proposed plan.³³

Furthermore, where a debtor fails to provide the court with important information regarding the debtor's ability to consummate the proposed, the court cannot accurately contemplate whether the debtor is capable of making the projected payments and will likely reject the plan. For example, in *In re Clarkson*, the debtor failed to file operations reports, audit reports and tax returns for the last five years.³⁴ Because the debtor had not provided the court with this income and managerial data, the court could not determine whether the debtor would be capable of making the proposed payments to its creditors.³⁵ Consequently, the *Clarkson* court refused to confirm the debtor's proposed plan.³⁶ Likewise, if the debtor may incur additional financial obligations in the future, but has not included provisions in its plan that account for

³⁰ *In re Clarkson*, 767 F.2d at 420.

³¹ *In re Lakeside Global II, Ltd.*, 116 B.R. 499, 507 (Bankr. S.D. Tex. 1989) ("Where the financial realities do not accord with the proponent's projections or where the proposed assumptions are unreasonable, the plan should not be confirmed.").

³² *In re Diplomat Constr., Inc.*, 2009 WL 6498180, at *2 (Bankr. N.D. Ga. Nov. 20, 2009).

³³ *Id.* at *3.

³⁴ *In re Clarkson*, 767 F.2d at 420.

³⁵ *Id.*

³⁶ *Id.*

such future obligations, the court could decide to not confirm the plan, depending on the circumstances.

III. Feasibility in Light of Ongoing Civil Litigation

A court must consider any pending civil litigation involving the debtor when determining the feasibility of a proposed plan, even if doing so goes beyond the scope of the chapter 11 bankruptcy case and outside the four corners of the plan itself.³⁷ This requirement is important because the outcome of such litigation has the potential to drastically change the financial state of the debtor, whether it be for better or for worse, which in turn could affect the debtor's ability to consummate its proposed plan. Consequently, a debtor's plan may not be confirmed if it relies on the outcome of pending litigation with creditors without accounting for the possibility that the debtor may not ultimately be successful in such litigation.³⁸

Just because there is pending civil litigation with a potential creditor, however, it does not necessarily follow that the plan is not feasible.³⁹ The court can exercise its discretion in evaluating the feasibility of a chapter 11 plan when there is ongoing civil litigation involving the debtor.⁴⁰ In examining how a civil case affects the feasibility of a debtor's reorganization plan, a court will first consider the merits of both parties' arguments in the lawsuit to determine what is

³⁷ See *Harbin v. IndyMac Bank FSB (In re Harbin)*, 486 F.3d 510, 514 (9th Cir. 2007) (holding that a bankruptcy court considering the feasibility of a chapter 11 reorganization plan must evaluate the effect of any ongoing litigation between the debtor and a potential creditor, whether that litigation is at the trial or appeal level).

³⁸ *In re DCNC N.C. I, LLC*, 407 B.R. 651, 667 (Bankr.E.D.Pa.2009) (holding a debtor's plan was not feasible where its reorganization strategy relied on its success in pending litigation with a creditor).

³⁹ See *In re Sagewood Manor Associates Ltd. P'ship*, *supra* note 36 (ongoing civil litigation is only one of many factors the court considers when determining whether a plan is feasible).

⁴⁰ *In re ELL 11, LLC.*, 2008 WL 916695, at *2 (Bankr. M.D. Ga. Apr. 2, 2008) ("While the court consider[s] the presence of ongoing litigation, it is not bound to deem the plan unfeasible merely because of the presence of ongoing litigation between a debtor and a claimant.")

likely to transpire, and then examine the effect that outcome will have on the debtor's ability to execute its reorganization plan.⁴¹

A. Reorganization Plans that Depend on Debtor's Success in a Pending Civil Case are Unfeasible

While the mere potential that a plan may fail will not render it unfeasible, the court refuse to confirm a plan if the plan is dependent on a certain outcome in an ongoing civil case.⁴² For example, in *American Capital Equipment, LLC v. Bartel*, the proceeds from a twenty percent surcharge for claimants who decided to opt into the plan's settlement process were to be the sole source of funding for the debtor's proposed plan.⁴³ Accordingly, the court held that the plan was not feasible because the plan was "highly speculative" because it depended entirely on the assumption that enough of the claimants would participate in the plan's settlement process.⁴⁴ Similarly, in *In re DCNC N.C. I, LLC*, the debtor's success in an ongoing action played a central role in the reorganization strategy, but the debtor could not demonstrate a sufficient likelihood of success in that action, so the debtor's motion to confirm the plan was denied.⁴⁵ Likewise, in *In re Thompson*, the debtor proposed to fund in his plan with the proceeds from all of his pending litigation, which he estimated would be \$21 million. The court refused to confirm the plan, however, because the court found that (1) there was no evidence to corroborate the estimated recovery and (2) there was no other source of funding available.⁴⁶ Finally, the court in *In re Cherry* held that a plan which depended on the debtor settling or obtaining judgment in a

⁴¹ *Id.* (confirming debtor's plan despite ongoing litigation with creditor, Chase, because Chase's claims were disallowed, therefore, unlikely to succeed on appeal.)

⁴² *In re Seasons Partners, LLC*, 439 B.R. 505, 514–15 (Bankr. D. Ariz. 2010) *order confirmed*, 2010 WL 6556774 (Bankr. D. Ariz. Nov. 8, 2010) ("The prospect of financial uncertainty does not defeat plan confirmation on feasibility grounds since a guarantee of the future is not required. The mere potential for failure of the plan is insufficient to disprove feasibility.") (internal quotations omitted).

⁴³ *American Capital Equipment, LLC v. Willard E. Bartel (In re Am. Capital Equip.)*, 688 F.3d 145, 156 (3d Cir. 2012).

⁴⁴ *Id.*

⁴⁵ *In re DCNC N.C. I, LLC*, 407 B.R. at 667.

⁴⁶ *In re Thompson*, No. 92–7461, 1995 WL 358135, at *3–4 (Bankr.E.D.Pa.1995).

personal injury suit within five years as a source of funding to make payments to creditors was not feasible.⁴⁷

B. Reorganization Plans Confirmed When Debtor Presents Sufficient Evidence of its Probable Success in an Ongoing Civil Case

Although courts are likely to deny a reorganization plan when the source of the plans funding are uncertain, where there is evidence to convince the court that the merits of an adverse party's claim in ongoing civil litigation are weak the plan could be deemed feasible.⁴⁸ Recently, in case *In re RCS Capital Development, LLC*, the Bankruptcy Appellate Panel of the Ninth Circuit was sufficiently convinced that debtor, RCS, would succeed in ongoing civil litigation.⁴⁹ There, RCS owed creditor ABC \$41 million, and had an enforceable judgment against ABC for \$57 million.⁵⁰ Thus, in its proposed plan, RCS included a provision that the \$57 million judgment would be used as a setoff while ABC was simultaneously appealing that judgment.⁵¹ However, the plan did not include any provision that provided the possibility that, on appeal, ABC might obtain a judgment against RCS not subject to setoff.⁵² Nevertheless, the court determined that ABC had a sufficiently small chance of success on their claim and confirmed RCS's reorganization plan.⁵³

Conclusion: Implications of Pending Litigation

⁴⁷ *In re Cherry*, 84 B.R. 134, 139 (Bankr.N.D.Ill.1988).

⁴⁸ *In re Seasons Partners, LLC*, *supra* note 49.

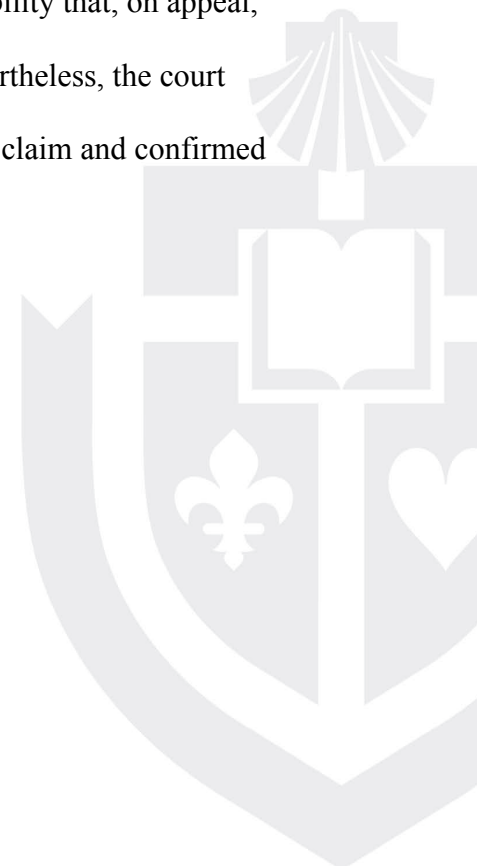
⁴⁹ *In re RCS Capital Dev., LLC*, 2013 WL 3619172 (B.A.P. 9th Cir. July 16, 2013)

⁵⁰ *Id.*

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*



When a business is seeking to reorganize under chapter 11, the bankruptcy court closely examines a debtor's current financial state to ensure that appropriate accommodations are made in order to allow debtor to emerge from bankruptcy as a viable entity. As such, ongoing civil litigation between chapter 11 debtors and parties-in-interest are a major concern to bankruptcy courts when considering the feasibility of a debtor's reorganization plan. When the success of a debtor's plan hinges on an uncertain result of ongoing litigation, the court is more likely to deny the plan than to confirm it.

As seen in *In re RCS Capital Development, LLC*, however, a debtor's chapter 11 plan for reorganization may be confirmed even if it does not account for every possible outcome of pending civil litigation. According to the court's holding in that case, a debtor should be aware that bigger lawsuits are likely to matter to the court when considering confirmation of a plan, while small lawsuits are likely to be irrelevant. Thus, if a debtor is involved in a high stakes lawsuit, it should draft a provision in the reorganization plan for the possible effects of the lawsuit. Furthermore, if a debtor is uncertain about what the outcome of a pending civil case will be, the debtor should not make success an essential part of its reorganization plan.

Therefore, debtors who are parties in ongoing civil lawsuits should include provisions in their plans for all possible outcomes unless they also include sufficient evidence that they will be successful in their civil suits. Such debtors must also consider that if the only funding for their plan is money to be collected from ongoing lawsuits, the court will find the plan is unfeasible. If debtors keep these facts in mind while drafting their reorganization plans, then they may be able to avoid unnecessarily burdening their respective estates with extra costs associated with drafting new plans on appeal after the court denied the original.