Focus on Feasibility

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One of the most significant changes to chapter 11 of the Bankruptcy Code in the 2005 amendments was the absolute limit placed on extensions of the exclusivity periods. Courts no longer have the discretion to extend a debtor's exclusive periods to file and solicit a plan beyond 18 months and 20 months, respectively, after the petition date. Although the legislative history contains no explanation for why this change was made, Congress presumably intended to accelerate the reorganization process or facilitate the prospects for competing plans in large, complex cases. Given that the first cases filed after the amendments took effect in October 2005 are now just reaching the 18-month milestone, it remains to be seen what effect this change will have.

For a number of reasons, however, one result of the new exclusivity limits is likely to be increased litigation over, and an increased focus on, the plan "feasibility" requirement. As an initial matter, parties have greater incentives to challenge the feasibility of a plan. A creditor group may challenge feasibility in an attempt to delay the case until the creditor group can file its own plan, or where competing plans have been filed, in an attempt to defeat the competing plan. Moreover, in a competing plan context the relative feasibility of the plans may become a focus in soliciting creditor support. Plans may also be more vulnerable to feasibility attacks. Debtors will have had less time in chapter 11 to demonstrate that operational and strategic changes are likely to lead to the projected improvements in financial performance under the proposed plan. In addition, in light of the substantial debate in recent years over repeat chapter 11 filing rates and the contention by some commentators that higher repeat filing rates are partly attributable to a purported lack of enforcement of the feasibility requirement, it is possible that courts will require that a plan proponent demonstrate a higher likelihood of success to meet the feasibility requirement. Add to these factors the increasing prevalence of hedge funds and other distressed investment funds that often take an active, aggressive role in the restructuring and have the financial wherewithal to propose competing plans and litigate their positions, and the potential for increased litigation over feasibility appears all the more likely.

The Feasibility Requirement

Pursuant to section 1129(a)(11) of the Bankruptcy Code, a plan of reorganization may be confirmed only if "[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 plan . . . ." This "feasibility" requirement had its origins in various provisions of the Bankruptcy Act of 1898, which required that the court find that the plan was "feasible." As the United States Supreme Court stated in 1936 in *Tennessee Pub. Co. v. American Nat. Bank*: "However honest in its efforts the debtor may be, and however sincere its motives, the district court is not bound to clog its docket with visionary or impracticable schemes for resuscitation." The oft-cited modern day incantation of this maxim was articulated by the Ninth Circuit Court of Appeals in *Matter of Pizza of Hawaii*, which remarked that the purpose of subsection 1129(a)(11) is "to avoid confirmation of visionary schemes which promise creditors more under a proposed plan than the debtor can possibly attain after confirmation."

Consistent with the plain language of the text, courts have uniformly held that the feasibility requirement does not require a guarantee of the plan's success, but rather that the plan offer "a reasonable prospect" or "reasonable assurance" of success. Courts, however, have sometimes varied widely in their determination of how likely success has to be under the circumstances presented.

The plan proponent bears the burden of proof to establish by a preponderance of the evidence that the plan is feasible. Factors recognized by the courts as relevant to evaluating the feasibility of a proposed plan of reorganization include: the prospective earnings or earning power of the debtor's business, which must be based on sound and reasonable assumptions; the adequacy of the capital structure and working capital for the debtor's post-confirmation business; the debtor's ability to meet its capital expenditure requirements; economic conditions; the capability of management and the likelihood that current management will continue; and any other material factors that would affect the successful implementation of the plan.

Courts have an affirmative obligation to evaluate a plan's likelihood of success and to make a particular finding as to feasibility. Thus, when feasibility is not contested, at a minimum the court itself must ensure that there is adequate evidence to support a finding that the plan is feasible. This typically will consist of the unimpeached testimony from an officer of the debtor (or representative of the plan proponent) and possibly the debtor's financial advisor or other retained expert, if applicable. The extent of the court's role and analysis, however, may vary considerably depending upon whether there is an active creditor constituency in the case.

In small business cases where there is not active creditor involvement, the court can serve an important role in ensuring that the debtor has undertaken the necessary planning and analysis and can adequately explain the basis for projections and related assumptions. While the court will not conduct its own analysis of the debtor's prospects for success, the court does play an important gatekeeper role by ensuring that the debtor has undertaken the appropriate planning and analyses.

In large corporate chapter 11 cases, however, the debtor’s projections and the adequacy of the debtor’s capital structure upon emergence typically have been evaluated not only by the debtor’s retained financial advisors, but also by the financial advisors for the various creditor constituencies. And when confirmation is uncontested, the court is presented with uncontested expert testimony regarding the reasonableness of the projections and adequacy of the capital structure. In these circumstances, the court’s role is essentially limited to reviewing the uncontested testimony and, to the extent that the court determines it necessary, requesting further explanation or clarification. In other words, the court will not perform any independent assessment of the reliability and accuracy of the uncontested testimony, and it would be a rare case where the court determines that the feasibility requirement is not met.

Challenges to Feasibility

When feasibility is contested, the court, consistent with its role in adjudicating any complex commercial dispute, will weigh the competing evidence and expert testimony and determine whether the plan proponent has met its burden to establish that the plan is feasible. Although courts have adopted varying views as to how likely success has to be for the plan proponent to meet its burden, if the purpose of the feasibility requirement is to avoid confirmation of "visionary or impracticable schemes" that are likely to be followed by a need for further reorganization, one would expect that, most of the time, the plan proponent, with its supporting expert testimony, will prevail in a dispute over the feasibility requirement.

Over the last few years, however, several factors have raised the visibility of failures by companies after emerging from chapter 11. There have been a significant number of repeat chapter 11 filings, so called "Chapter 22s," in recent years. Moreover, based on empirical findings relating to repeat filing rates, there has been much debate regarding the role of bankruptcy courts in large chapter 11 cases and, in particular, whether there exists a harmful competition among courts for large cases. In connection with this debate, some commentators have contended that the Delaware and New York bankruptcy courts, purportedly in an effort to attract large cases, have abdicated their responsibility to enforce the "feasibility" requirement under the Bankruptcy Code. Given the prevalence of this debate and the number of repeat filings, courts may be increasingly likely to require a higher threshold of proof (*i.e.*, a higher level of assurance of success) to satisfy the feasibility requirement.

Regardless of whether courts may apply a higher threshold, when feasibility is challenged, and especially when there is a competing plan or the prospect of a competing plan, support of the debtor's various stakeholders will play a key role in the outcome. If the plan is broadly supported by the debtor's constituencies, the court may very well conclude that the feasibility requirement has been met, even if the court is concerned from the evidence that the debtor's assumptions and projections are aggressive and prospects for success somewhat questionable. In fact, some courts have expressly concluded that the threshold for feasibility is reduced if plan confirmation is widely supported by creditors.

Conversely, if the feasibility of the plan is challenged by constituencies that will have a significant stake in the reorganized entity, as opposed to merely an out-of-the-money constituency seeking to leverage a nuisance settlement, the court is likely to require the plan proponent to establish that the plan have a higher likelihood of success, especially where the challenging constituency is proposing to file its own plan that does not have the same risks of failure.

When there are competing plans, the relative feasibilities of the plans may become a determining factor in which plan is confirmed. If multiple plans are being solicited simultaneously, the disclosure statements may contain plan proponents' contentions or opinions regarding the deficiencies of the competing plan, including the risks that the competing plan will not be consummated or reasons why projections underlying the competing plan may not be met. In this situation, creditors are typically sent a ballot on which they are asked to accept or reject each plan and, if accepting each plan, indicate which plan they prefer. Although bankruptcy courts are required to consider the preferences of creditors when choosing between confirmable plans, bankruptcy courts are not bound by those preferences and generally have determined to balance creditor preferences with other factors, including the relative feasibilities of the plans. Thus, if each plan receives the requisite acceptances for each impaired class and there is not an overwhelming preference among the creditors for one plan over another, the relative feasibilities of the two plans may well determine which plan prevails. Even in cases where there is a clear creditor preference for one plan over another, the less preferred plan may still prevail if the preferred plan has substantially less assurance of success. For example, one plan may contemplate the sale of the debtor's assets and payment of cash to creditors, while the other plan is dependent upon the future success of the debtor's operational changes and strategies — success that the court may determine, after considering the evidence, is questionable.

Avoiding Feasibility Problems

There are a number of things that debtors can do throughout the restructuring process to minimize the possibility of a plan feasibility challenge. As early as possible in the process, a debtor should develop its strategic business plan and begin implementation of the operational changes contemplated therein. It is critical to have at least some track record of operating results prior to the development of financial projections, and the longer the period of operating results is, the more supportable the financial projections will be.

Once negotiations with creditors on the terms of the reorganization begin, those negotiations should take into account the ability to defend the proposed capital structure upon emergence, including the ability to demonstrate the availability of sufficient liquidity to operate the business and meet any post-bankruptcy debt service obligations. There can often be a substantial period of time between the commencement of negotiations and actual plan confirmation, and operating results or changes in industry conditions during that time may necessitate revisions to the financial projections and the obligations contemplated by the plan. Thus, to the extent the payment of cash or the issuance of debt instruments to creditors is contemplated, it may be necessary to negotiate some form of "relief provision" that would permit a reduction or modification of the obligation if, at the time of confirmation, it turns out that there is insufficient liquidity to support the required payments. For example, a class of creditors may be offered a pro rata share of a specific amount of cash if exit financing sufficient to enable such payment can be obtained or, if sufficient exit financing cannot be obtained, promissory notes to be paid over time.

With respect to the development of the business plan and financial projections, it is best to take a conservative approach and to ensure adequate involvement of operational management. Projections that forecast dramatic improvements over a short period of time or performance that is significantly greater than historical results are vulnerable to attack. Thorough testimony to support the reasonableness of the assumptions underlying the projections will be critical in the event of a feasibility challenge. This includes assumptions regarding general business and economic conditions and industry trends as well as operational and financial assumptions. The debtor’s performance to date will often be the most important factor in establishing that it is reasonable to expect that the debtor will meet or exceed projections. It is also important to provide testimony establishing that the debtor will remain viable even if it falls short of the projections. This may include, for instance, testimony about the existence of excess liquidity to deal with unforeseen events.

Perhaps the most important step a debtor can take in avoiding a feasibility attack is to keep its creditor constituencies informed and involved throughout the process. For instance, creditors should be given the opportunity to review and comment on the business plan before major steps to implement it are taken. Creditors should also be given access to information relating to the development of the financial projections as soon as practicable so that any issues can be vetted as early as possible. Ultimately, the best defense against any feasibility challenge is broad creditor support of the plan.

Tennessee Pub. Co. v. American Nat. Bank, 299 U.S. 18 (1936).

Matter of Pizza of Hawaii, Inc., 761 F.2d 1374 (9th Cir. 1985).

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