AMERICAN BANKRUPTCY INSTITUTE
JOURNAL
Issues and Information for the Insolvency Professional

Chapter 11 - "101"

The Life Cycle of a Chapter 11 Debtor Through the Debtor's Eyes

Part II

Contributing Editors:
Prof. John D. Ayer
University of California at Davis
Chico, Calif.
jdayer@ucdavis.edu

Michael Bernstein
Arnold & Porter; Washington, D.C.
michael_bernstein@aporter.com

Jonathan Friedland
Kirkland & Ellis LLP; Chicago
jonathan_friedland@chicago.kirkland.com

Editor's Note: *This is the third in this column series for the newly minted chapter 11 professional. In our last installment, we began to paint a portrait of a chapter 11 debtor's life, from preparing for a bankruptcy filing to first-day hearings, the effect of the automatic stay, financing issues and the treatment of executory contracts. Last month's cliffhanger left the debtor having successfully filed its case and learning to operate in chapter 11. This month, we take the reader on a quick tour of the "rest" of the case.*

Any entity that subjects itself to chapter 11 obviously has some serious problems that need to be fixed. Here, we examine the nature of the fix. Broadly stated, there are two ways chapter 11 helps a debtor deal with its problems. First, it provides the debtor with a host of powers that can help it to remedy operational problems. The ability to reject executory contracts and unexpired leases is one well-known example. Second, chapter 11 enables a debtor to restructure its balance sheet to better reflect the actual—and usually diminished—ability of the business to service debt. This is accomplished through the formulation and approval (the "confirmation") of a chapter 11 reorganization plan.

Insofar as chapter 11 often is just a matter of making a deal with various stakeholders, one may well ask, "why can't you just do it all informally, without the cost, inconvenience and stigma of a bankruptcy case?" The answer is you can, and often you do when you don't need to use unique "bankruptcy powers" to make an operational fix. Plenty of times a debtor and its creditors can simply make and carry out deals without court intervention, so much so that some people even refer to an out-of-court workout as a "private chapter 11."

But chapter 11 does permit you to accomplish some purposes that you may not be able to achieve on your own. Here are a few:

- Perhaps most important, if you get the right number of votes, you can impose the plan on dissenters (while outside of chapter 11 you may not even be able to find all of the creditors, much less get their attention or their consent).
- Because of the automatic stay, you get to hold creditors at bay while you try to make your deal.
- You get a "cleaner deal" than you may be able to get outside bankruptcy—more clarity and finality about the rights of the parties.
- You get to use some of those bankruptcy powers that simply aren't available anywhere else.

The confirmation of a plan may be viewed as the last step in the fix, or alternatively as a description of what the fix is and how it will be implemented. A confirmed plan becomes the "law of the case"—a substitute contract that replaces the old creditor claims and equity interests.

Some debtors, as we discussed in a prior column, do not use chapter 11 to reorganize, but as a forum for an orderly liquidation. But even in those cases, the plan is the "fix" that dictates the parties' rights—who will sell the assets, how they will be sold, over what time period and who will receive the proceeds. It is worthwhile to note that, with increasing frequency, the "fix" that is seized upon by debtors is a sale of all or substantially all estate assets under Bankruptcy Code §363 rather than a reorganization plan—a phenomenon that may make some bankruptcy judges feel like auctioneers—but the prototype is still a chapter 11 plan, and so we discuss that here and leave §363 sales for a future discussion.

It is impossible to generalize what activities and events will occur in any particular chapter 11 case because each case is so different. However, the typical chapter 11 case does involve certain interrelated groups of activities or processes. These include claims administration, avoidance and confirmation. We offer some thoughts on each below.

There is no rule that prescribes the order in which such tasks must be completed. Rather, when, or even if, these activities will take place in any given case will depend on a multitude of factors, including whether the case involves a "free fall," "pre-arranged" or "pre-packaged bankruptcy;" whether the case involves a reorganization, liquidation or a sale of all assets to a third party; and the level of creditor cooperation. It will also depend on what issues are of most pressing concern in the particular case.

It should also be noted that the manner in which one of these tasks is performed may impact the others. For instance, the claims-administration process is sometimes a critical part of the plan-confirmation process. As we touch upon later, a plan cannot be confirmed unless the bankruptcy court makes a number of specific findings. One such finding is that the debtor will be able to pay most §503 and 507 "administrative" and "priority" claims—those claims that Congress has determined should enjoy priority over other unsecured claims—on the "effective date" of the plan. Thus, thinking ahead to confirmation, debtors sometimes spend great resources on claims administration, addressing not only the validity and amount of claims, but also their priority levels.

Claims Administration

If you are going to pay claims, you have to make sure you know whom to pay. If you are going to solicit votes on a plan, you have to know who gets to vote. If you are going to put claims into different classes, you have to know who goes in which class. So the problem of claims administration requires attention in even the simplest chapter 11 case.

The debtor gets the ball rolling by filing schedules of all its debts. If you are a creditor and the debtor has scheduled your claim correctly, that is enough to put you on the list. If not, you can file a claim (but for what it is worth, your authors would ordinarily file a claim in any event, just to be sure) prior to the applicable deadline (or "bar date").

After there is a complete list of "possible" claims, as a result of the schedules and the proofs of claim, the debtor and other parties have the chance to assert objections. Sometimes these are asserted on a claim-by-claim basis; other times the objections will fall into broad categories and you will see "omnibus objections"—a single pleading objecting, for a similar reason, to dozens or even hundreds of claims. Here are some common objections:

- The claim is invalid under non-bankruptcy law. For the most part, you don't have a claim in bankruptcy unless you would have a claim against the debtor outside bankruptcy, so this objection can be a knockout punch.
- The claim is valid but overstated (the debtor's books and records reflect a lower amount due).
- The creditor is holding money or property of the debtor that he must return before his claim is allowed. (*See* §502(d)).
- The claim was filed too late. Claims filed after the bar date may be disallowed or subordinated.
- The creditor asserts the wrong priority. High-priority claims get paid before low-priority claims. As a general matter, knocking the creditor down the priority ladder reduces his chance of getting paid.

Aside from allowing claims for payment, there is the matter of establishing claims for purposes of voting on the plan. To understand this point, you have to know a bit about the voting rules. When read together, §§1126 and 1129 provide that any creditor who is "impaired" by a plan gets a chance to vote on the plan. Creditors vote by classes. To confirm a plan, you have to get the approval of a majority in number and two thirds in amount of claims in each voting class. So, just as for payment, it matters for purposes of voting whether the creditor has an "allowed" claim, how big it is, and what class the claim is in.

As to classification: Section 1123 provides that the plan may "designate.. .classes of claims." Section 1122 says you may put a claim in a particular class only if the claim is 'substantially similar' to other claims in the same class. But you may be able to take claims that appear similar for non-bankruptcy law purposes and put them in different classes for purposes of the bankruptcy plan. This happens often enough that some of the worst fights in chapter 11 involve plan classification, with the dissenters arguing that the plan proponent is "gerrymandering" the classes, while the proponent argues that there is a principled basis for its classification scheme.

Avoidance

By avoiding a particular transfer of property, the trustee or debtor-in-possession (DIP) can cancel a pre-petition (or, occasionally, an unauthorized post-petition) transaction and force the return or "disgorgement" of the payments or property, which then are available to pay all creditors pursuant to the priority rules set forth in the Bankruptcy Code. These powers are used to prevent unfair pre-petition payments to one creditor at the expense of all other creditors. Below are the common avoidance powers in chapter 11.

Fraudulent Transfers: A pre-petition transfer may be avoidable as either "intentional fraud" or "constructive fraud." The former is a transfer made with actual intent to hinder, delay or defraud creditors. Think of the debtor-to-be who is being hounded by creditors, and so conveys his house and his bank account to his mother so that the creditors won't seize them. The latter is a transfer made for less than reasonably equivalent value, while the debtor is insolvent (or which renders the debtor insolvent or leaves it with unreasonably small capital). Also within this category could be the sale of a $10 million factory for $3 million, or the payment of a dividend to shareholders by an insolvent corporation, even if there were no intent to harm creditors.

The Bankruptcy Code includes its own fraudulent transfer power, set forth in §548. But a trustee (or DIP) may also utilize state fraudulent conveyance laws, which tend to be generally similar to the federal statute, but with significantly longer reach-back periods.

Strong-arm Powers: Now, here is a different case. Before bankruptcy, the debtor borrowed $1 million from BigBank and, to secure the loan, granted BigBank a security interest in its equipment. Typically, if BigBank wants to beat out competing third-party contenders, he will have to "perfect" this security interest—probably by filing a "financing statement" in the public records. If he fails to perfect, he will lose out to a competing creditor who gets a lien, or share ratably with unsecured creditors.

Recall that the trustee is a kind of agent of creditors. So it is not surprising to learn that the trustee enjoys the rights of a lien creditor. In our case, this means that if the security interest is unperfected at the time of the bankruptcy filing, the trustee gets to set it aside. *See* 11 U.S.C. §544(a).

Preferences: Now, still another case. The debtor owes $10 each to the butcher, the baker and the candlestick maker. The debtor has assets worth only $10. He transfers all his assets to the butcher in satisfaction of the butcher debt, leaving the baker and the candlestick maker unpaid. What is the result? Observe that under the two rules we described above, it is probably bulletproof. There's nothing to indicate it could be set aside by a lien creditor. It (probably) wasn't done to defraud other creditors, and the debtor did get fair value for the payment (satisfaction of the $10 debt). Quite the contrary: Whatever the debtor did here, at least he paid a debt.

Preferring one creditor over another usually is not wrong outside bankruptcy. But bankruptcy is all about distributing assets among creditors "as their interests may appear." If you let the debtor pick and choose whom he pays, you may upset the purpose of bankruptcy. Thus, bankruptcy law allows a trustee (or DIP) to avoid certain pre-petitition debt repayments even though they would not be avoidable outside of bankruptcy. *See* 11 U.S.C. §547. Typical examples of preferential transfers include the late payment of a trade debt (outside the "ordinary course of business"), the granting of a security interest to a previously unsecured or undersecured lender, and delayed perfection of a security interest granted by the debtor at the time it incurred an earlier debt. The reach-back period for preferences is 90 days before bankruptcy, although it extends to one year if the recipient is an "insider" of the debtor (for definition of "insider," *see* §101(31)).

Vats of ink have been spilled over the trustee avoiding powers, and we don't do any more than hint at the difficulties here. We intend to devote a separate column, maybe two, to the topic later on. We raise the topic here mostly for one reason: The way you manage the avoiding powers may drive the chapter 11 case. In some cases, the avoiding powers provide the motive for filing—either to recover the transfer or to use the threat of doing so to reach a deal. On the other hand, there may be cases where we will finesse the avoidance problems in order to make a deal that wouldn't happen otherwise.

Confirmation

Here is the basic chronology in confirming a plan:

- Negotiate a plan with creditors (or their agents).
- Draft a plan and "disclosure statement."
- Get court approval for your "disclosure statement."
- Only after getting that approval, solicit votes from holders of impaired claims.
- Count the votes.
- Ask the court to confirm your plan.

Plan Formulation. Key to the timely confirmation of a plan is a well-defined exit strategy. The plan proponent must determine what exactly it wants from the reorganization, and how, from a business perspective, it plans to achieve it. Most often, the chapter 11 plan is proposed by the debtor. And during the "exclusive period" (the first 120 days of the case, or longer if the court grants an extension—which it often does), the debtor has the sole right to propose a plan. But after the exclusive period expires, other parties may propose a plan—and if you play this game long enough you will see some plans proposed by creditors' committees, secured lenders and other parties. That is why we refer later on to the "plan proponent" rather than the "debtor."

Plans may, and frequently do, provide for comprehensive changes in the financial and business structure of the debtor. Such changes may include sales of assets, cancellation or refinancing of debt (or conversion of debt to equity), curing or waiving of defaults, satisfaction or modification of liens, amendment of the debtor's corporate charter, or changes in the amount, interest rate or maturity of outstanding debt.

A plan can provide that a creditor's claim will be reduced, or paid back over a greater period of time or at a different interest rate than was contained in the original instrument. Bankruptcy courts have confirmed plans with repayment periods of up to 20 years or longer. A plan can also cancel existing issues of stock, replace existing issues with new issues or swap equity for debt and vice versa.

Investors and would-be acquirers can use chapter 11 as a means for accumulating control of a debtor-corporation and for influencing the corporate governance of a debtor, taking actions that often would be more difficult outside the realm of bankruptcy. Articles of incorporation can be changed in a plan to change the voting rights of different issues of shares or modify anti-takeover measures.

The Disclosure Statement. No one may solicit acceptance of a plan until the court approves a "disclosure statement" sufficient so a voter can "make an informed judgment about the plan." 11 U.S.C. §1125(a)(1). The disclosure statement thus serves a function similar to a prospectus for an offering under securities law. (In addition, compliance with the disclosure statement requirements creates a limited safe harbor from certain securities laws requirements that would otherwise be applicable. *See* 11 U.S.C. §1145).

Since no one can solicit consents without a court-approved disclosure statement, the hearing on disclosure typically becomes the first point of contact between the plan and the court. There are sometimes fights about the adequacy of the debtor's disclosure statement. Most of the time, these really have more to do with confirmation than disclosure issues. Objectors often see the disclosure statement hearing as a first chance to raise concerns about the plan. In response, judges often tell such objectors to "save it for the confirmation hearing."

Solicitation. After the approval of the disclosure statement, the proponent solicits votes. Voting is done on a class-by-class basis. In order for a class to be deemed to have accepted a plan, the plan must be accepted by a majority in number of creditors who vote and at least two-thirds in debt amount of voting creditor claims in that class. For these purposes, the claims of insider creditors don't count. If every impaired class of creditors votes to accept the plan, the proponent then asks the court to confirm the plan. If no impaired class votes to accept the plan, then the plan is dead on arrival and the debtor must come up with something else, or head back to the bargaining table. If some impaired classes vote to accept and others vote to reject, then the proponent may seek to "cram down" the dissenting classes (see more about that below).

Basic tests for confirmation. Upon receipt of the necessary acceptances, the plan proponent will request the bankruptcy court to confirm the plan at the confirmation hearing.

The Bankruptcy Code requires the bankruptcy court to make a number of specific findings to "confirm" (approve) a plan and make it binding on all parties. These include determinations that the plan complies with all applicable law and has been proposed in good faith. The bankruptcy court must also determine that the plan is feasible (*i.e.,* that the debtor has a credible business plan and can reasonably be expected to perform its obligations and accomplish the objectives set forth in the plan).

If any individual creditor votes against the plan, then the plan must also pass the "best interests of creditors" test. This test requires the court to determine that the dissenting creditors or shareholders are receiving under the plan at least as much (in present value terms) as they would receive if the debtor were instead liquidated under chapter 7. It requires the court to compare (1) the probable distribution to the dissenting creditors or equity-holders if the debtor were liquidated with (2) the present value of the payments or property to be received or retained by the same creditors or equity-holders under the plan. Stated more simply, if a class votes in favor of the plan, the plan will be binding on dissenters in that class as long as dissenting class members are getting at least as much as they would get in liquidation.

If a class of creditors votes to reject the plan, it may nevertheless be imposed on the class ("crammed down") if (1) at least one impaired class has voted to accept the plan and (2) the court finds that the treatment provided for objecting classes under the plan does not "discriminate unfairly" and is "fair and equitable" (the "fair and equitable" test).

The prohibition against "unfair discrimination" means that, ordinarily, similar claims or equity interests must be treated in like manner. There are examples of "fair" discrimination, however. For example, the enforcement of a contractual subordination provision to subordinate the claims of one class to the claims of another class does not discriminate "unfairly" against the subordinated class.

The precise determinations required for meeting the fair-and-equitable test turn on whether the class is secured or unsecured. Cramdown of a secured class will be permitted if the plan provides (1) that the objecting secured creditor class will retain a lien to the extent of its secured claim and will receive deferred cash payments that have a present value equal to at least the value of the creditor's interest in the collateral, (2) for the sale of the secured creditor's collateral with the creditor's lien attaching to the proceeds or (3) for the realization by the secured class of the "indubitable equivalent" of its secured claim. (Nobody seems to know exactly what "indubitable equivalent" means, but one thing it may mean is returning the secured creditor's collateral to it in satisfaction of the secured claim.) The permutations of possibilities under the different cramdown options can become quite complex, but as a general rule they boil down to the secured creditor receiving at least the lien value of its collateral.

The fair-and-equitable test for unsecured claimants and shareholders is much simpler. Generally speaking, a class of unsecured claims can be crammed down if the plan provides either that the creditors in the class receive (over time) cash payments equal to the present value of their unsecured claims (*i.e.*, payment in full) or that junior classes (such as subordinated creditors or stockholders) receive nothing under the plan. Equity security-holders may be crammed down along similar lines. Cramdown cases are far more often threatened than confirmed, but the cramdown power provides important bargaining leverage.

Post-confirmation

Confirmation represents a significant achievement in a chapter 11 case, and it is generally viewed as the end goal of a filing; it represents consummation of the business "deal" between the relevant parties. Confirmation, like chapter 11 itself, should not be the goal in and of itself. Rather, chapter 11 is a venue for getting to a deal and confirmation is akin to the signing of the contract that memorializes the deal.

Moreover, in practical terms, confirmation does not end a case. A number of important aspects often remain to be completed after confirmation. This may include consummating transactions provided for in the plan, resolving claims and litigating adversary proceedings. ■

Reprinted with permission from the ABI Journal, *Vol. XXII, No. 8, October 2003.*