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CHAPTER 11 OF THE UNITED STATES BANKRUPTCY CODE: BACKGROUND AND SUMMARY
2012

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I. BACKGROUND OF CHAPTER 11 OF THE BANKRUPTCY CODE

A. Importance of Chapter 11.

Insolvency laws have existed around the world for centuries.[1] The US has long had its own bankruptcy laws[2] which, over they years, have sometimes been more creditor-friendly and sometimes more debtor-friendly. As a result of the enactment of the current Bankruptcy Code in 1978, US law now decidedly favors debtors by providing a unified and comprehensive treatment of business reorganization for financially distressed companies – found primarily in "Chapter 11" of the Code. This is not to say that US law disfavors creditors, but rather that the emphasis is on giving the management of a Chapter 11 the opportunity to reorganize the business, even under circumstances where secured creditors would rather foreclose on their collateral or where creditors overall would rather force a liquidation than spend time and money on attempting to reorganize a failing enterprise.

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Thus, Chapter 11 reflects the primary policy of US bankruptcy law for corporate debtors: to preserve and protect an ailing business by encouraging a financial restructuring that is binding upon all parties. Under Chapter 11, a distressed company has the opportunity to obtain a breathing spell from the demands of creditors, remain in business with existing management, reassess its business plan and negotiate (or seek to impose) a restructuring of its capital structure which binds all existing creditors and shareholders.

Since the enactment of the new Code in 1979, bankruptcy reorganization has become a

[1] The term "bankruptcy" itself comes from 13th century Venice when the benches of financial merchants in the town square would be broken ("banca rotta") if the merchant failed to pay its debts. In fact, the word "banca" is the source for the word "bank," which then gives us the phrases "to break the bank" and "to go broke."

[2] Note that, in the US, the term "bankruptcy" applies to all forms of court-supervised insolvency proceedings for legal and natural persons, whereas in most other countries "bankruptcy" refers

much more viable option for major corporations in financial distress. Corporations filing bankruptcy petitions and reorganizing under Chapter 11 have included some of the largest corporations in the United States, including Texaco, MF Global, Lehman Brothers, Enron, WorldCom, American Airlines, US Airways (twice), Delta Airlines, United Airlines, Owens Corning, Polaroid, Washington Mutual and LTV Corporation (twice). Chapter 11 has swept up major segments of the US economy such as retail, healthcare, e-commerce, timber, homebuilding, automotive, commerce, theater chains, grocery chains, airlines, manufacturers and telecoms. Reasons for seeking protection in bankruptcy have included the inability to meet debt payments, the inability to obtain new credit, extraordinary tort liability for defective products or environmental hazards, unexpected financial catastrophes, shifts in the US economy, and the underestimated difficulty of surviving change.

2 Notwithstanding the flexibility and support offered to a debtor, Chapter 11 is not a panacea. It should be considered only as a last resort when the necessary parties are unable, unwilling or unavailable to reach an agreement outside of court proceedings or when, as in the case of Lehman Brothers, there is nothing that can be done quickly enough outside of Chapter 11. Creditors have safeguards, remedies and strategies to maximize timely recoveries under Chapter 11, and to negotiate (or impose) a financial restructuring that is quite different from the desires of the debtor or its shareholders. Given the natural tensions between debtors and creditors, and the underlying policy of the Code in favor of financial rehabilitation, Chapter 11 and the bankruptcy courts have emerged as a significant forum for addressing nearly every major trend or catastrophe affecting the financial health and economic future of US businesses.

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just to liquidations and other terms (such as "administration".

B. Purpose and Process of Chapter 11.

The general purpose of Chapter 11 is to provide a meaningful opportunity to preserve the debtor's business as a going concern by restructuring its debt and equity interests to better reflect the actual (and usually diminished) ability of the business to service debt, and retain or create equity value for shareholders. This is accomplished through the formulation and approval of a financial restructuring plan (a "Plan").

A Plan can provide for a number of changes, including changes in the amounts, interest rates or maturities of outstanding debts, reinstatement of favorable existing contracts notwithstanding defaults, satisfaction or modification of liens, rejection or assumption of contracts and leases, attraction of new credit with senior liens, amendment of the debtor's corporate charter, and issuance of new debt or equity securities for cash, property, existing securities, or in exchange for old debt or equity interests. As part of this process, existing creditors usually see their debt claims reduced or modified, and they often become shareholders of the reorganized entity as well.

In contrast to reorganizations under prior US law and in many other countries, existing management normally continues to operate the business during Chapter I 1 proceedings and is expected to negotiate with creditors and frame a Plan for reorganization of the business. Further, to eliminate the delays and uncertainties inherent in the reorganization process under prior law, the Code is structured to foster a negotiating process that hopefully will lead to a consensual Plan. The Code retains, however, a mechanism for imposing a financial reorganization if a consensual Plan cannot be achieved, called "cramdown." After giving weight to the relative rights and remedies of the parties under applicable state and bankruptcy law, the bankruptcy court can approve ("confirm") a Plan that will be binding on all creditors and shareholders — even if they don't agree.

C. Chapter 11 Relief Not Restricted to Insolvent Entities.

A business need not be insolvent to obtain Chapter 11 relief. There is no requirement that its liabilities exceed its assets or that it even be unable to pay its debts as they come due. Solvent companies may, therefore, voluntarily file for liquidation or reorganization under the Code.

D. Entities Eligible for Chapter 11.

Generally speaking, almost any commercial enterprise can file for relief under Chapter 11. One important exception is the Bankruptcy Code provision which provides that stockbrokers and commodity brokers may only be debtors in a chapter 7 liquidation under the auspices of the Securities Investors Protection Act, which happened with a Lehman Brothers
4 broker-dealer subsidiary and an MF Global subsidiary. Individuals can also file for Chapter 11 relief. The only entities not eligible for relief under one or more chapters of the Code are: banking and insurance institutions; entities having no residence, domicile, place of business, or property in the United States; and governmental units that are not "municipalities." 11 USC § 109. The Bankruptcy Code restricts certain entities that are governed by other state or federal law in the event of financial distress.

II. <u>FILING OF A PETITION UNDER CHAPTER 11 AND ITS EFFECT</u>

A. Voluntary Versus Involuntary Petitions.

A Chapter 11 case can be commenced on a voluntary or involuntary basis. The debtor commences a voluntary Chapter 11 case by filing a petition for relief with the clerk of a bankruptcy court. The filing of a voluntary Chapter 11 petition automatically constitutes entry of an "order for relief" opening the case. 11 USC § 301.

As its name suggests, an "involuntary" case is commenced by an entity other than the debtor, usually creditors. Although most involuntary cases are commenced under Chapter 7 (seeking liquidation of the company), creditors may also commence an involuntary Chapter 11 case against a debtor. 11 USC § 303(a). Generally speaking, for most businesses three creditors with "bona fide unsecured claims" of at least $14,425[3] in the aggregate are needed to file an involuntary petition against a debtor. 1 1 USC § 303(b)(1). If the debtor contests the filing of an involuntary petition against it, the petitioning creditors are required to establish either that: (1) the debtor "is generally not paying [its] debts as they become due," unless such debts are the subject of a "bona fide dispute" (i.e., the company is in payment default on a substantial portion of its undisputed debts), or (2) a nonbankruptcy trustee or receiver has taken charge of substantially all of the debtor's property within the preceding 120 days (i.e., a receiver has been
5 appointed under state law for the foreclosure of liens on virtually all of the debtor's property). 11 USC § 303(h). If the debtor fails to timely contest the involuntary petition, or if the court decides that the statutory criteria have been met, the court will enter an "order for relief" and conduct the case like any voluntary Chapter 11.

B. Creation of the Bankruptcy Estate.

The commencement of a bankruptcy case creates a bankruptcy "estate." The estate is comprised of all property of the debtor, "wherever located and by whomever held," including all legal and equitable property interests of the debtor as of the time of commencement of the case, property of the debtor recoverable from third parties, and proceeds, rents, profits from property of the estate. 11 USC § 541. It is intended to be a broad and far-reaching concept that touches every property interest of the debtor. The property of the estate, whether utilized in a going-

[3] This and certain amount/amounts in the Code are indexed and adjusted from time to time.

concern business or sold separately, serves as the basis for generating and/or measuring creditor recoveries under a Plan.

C. Primary Parties in the Reorganization Process.

1. Debtor in possession or trustee.

In a reorganization case under Chapter 11, the debtor entity and its existing management ordinarily continue to operate the business as a "debtor in possession." 11 USC §§ 1107-08. The court can appoint a trustee to take over management of the debtor's affairs only for "cause," including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management. 11 USC § 1104. However, such appointments are rare.

2. Role of creditors' committee and other official committees.

Creditors are not permitted a direct role in operating the ongoing business of the debtor in Chapter 11. At the inception of the Chapter 11 case, however, the United States Trustee (discussed below) will appoint a committee of creditors holding unsecured claims (usually the seven largest unsecured creditors willing to serve). 11 USC § 1102. Generally speaking, the creditors' committee monitors the debtor's ongoing operations, consults with the debtor on major business decisions, and can be very influential in the case. A creditors' committee in a Chapter 11 case can, with court approval, hire attorneys, accountants, investment bankers, and other agents to perform work for the committee. 11 USC § 1103. At the United States Trustee's discretion, committees representing other constituencies (e.g., equity security holders) can also be appointed in the Chapter 11 case. 11 USC § 1102(a)(2).

3. Role of the United States Trustee.

The United States Trustees serves in various administrative capacities in the case. Responsibilities include monitoring employment and compensation of professionals hired in the case by the debtor or the official committees, monitoring the filing of required financial schedules and reports by the debtor, and appointing and monitoring the members of the official committees in the case. Trustees are also entitled to comment upon the feasibility of Plans and the adequacy of the disclosure statements filed with the Plans and are also expressly authorized to move for dismissal of bankruptcy cases.

4. Other parties in interest.

Other creditors and shareholders can participate in the case and be heard on most issues as "parties in interest." 11 USC § 1109.

Frequently "ad hoc groups" of creditors that are similarly situated may form a group and become active in the bankruptcy case. Often these groups exercise more leverage and influence than individual creditors acting on their own. The Securities and Exchange
7 Commission ("SEC") can also be heard on most issues, although it cannot appeal any decision. 11 USC § 1109(a). Further, in some cases other "interested" parties, such as governmental authorities, unions and retirees, are entitled to be heard on particular issues. There is currently a dispute in the bankruptcy world as to whether Bankruptcy Rule 2019 requires members of ad hoc groups to disclose their trading history in terms of when purchased and price paid.

D. Automatic Stay.

1. Trigger and general effect on creditors.

The commencement of a bankruptcy case triggers an "automatic stay" which, with certain exceptions, operates as an injunction (prohibition) against all actions affecting the debtor or its property. 11 USC § 362(a). The automatic stay provides a respite and breathing spell for the debtor, and also protects the creditor body as a group by bringing to a halt all actions by individual creditors to obtain satisfaction of their claims using the remedies available under state law. The stay operates regardless of whether a creditor has notice of the filing of a bankruptcy petition. Any action taken in violation of the stay generally is void. Persons violating the stay can be held liable for damages, even including punitive (exemplary) damages in rare cases. See 11 USC § 362(h).

Under the automatic stay, the holder of a security interest in the debtor's property may not repossess or foreclose on that property without the permission of the bankruptcy court. Acts to create or perfect a lien on the debtor's property are generally stayed as well. In addition, the stay halts all efforts by both secured and unsecured creditors to collect from the debtor prepetition debts owing to them, including demands for payment, lawsuits or attachments, etc.

2. Effect on debtor.

The automatic stay provides the debtor with a breathing spell in which to seek to reorganize without being pressured by the seizure of assets or the commencement of litigation outside of the bankruptcy court. The debtor is temporarily relieved of paying its prepetition debts currently. Since many bankruptcy filings are precipitated by cash shortages to meet current debts and expenses, the automatic stay can provide a significant cash benefit to a debtor attempting to reorganize. While the Chapter 11 case is pending, the debtor needs only to pay postpetition wages, expenses, trade payables, taxes and administrative Chapter 11 expenses (such as professional fees) to keep its business going. In the meantime, it can focus on a permanent financial restructuring of all prepetition claims. The automatic stay, however, is intended as only a temporary relief for the debtor. Final relief for the Chapter 11 debtor is reserved for the Plan.

3. Limited exceptions.

An implied, but important, exception to the scope of the automatic stay is that it does not usually protect parties who are not themselves in bankruptcy, such as guarantors. Moreover, the Code also expressly carves out a number of exceptions to the scope of the automatic stay. 11 USC § 362(b). The exceptions principally relate to the continuation or commencement of various types of regulatory actions by governmental authorities against the debtor, such as environmental cleanup orders or OSHA compliance actions. Those few acts or proceedings that are not automatically stayed may nevertheless be enjoined by court order if the equitable standards for the issuance of an injunction have been met.

E. The Concept of Adequate Protection for Secured Creditors.

In the first instance, the automatic stay prevents a secured creditor from foreclosing on its collateral. The Code attempts to balance, however, the beneficial aspects of the automatic stay to the debtor against the corresponding enforcement delays imposed on secured creditors, or the possible decline in the value of the collateral while the property is being used by the debtor during the case. One of the ways in which the Code balances the competing interests of the debtor and secured creditors is to require that the secured creditor be "adequately protected" against declines in collateral values during he pendency of, and as a result of, the Chapter 11. If a debtor opposes a creditor's motion for relief from stay, the debtor carries the burden of showing that the creditor's interest is or will be adequately protected. 11 USC § 362(g). If the debtor is unable to provide adequate protection, then a secured party is entitled to obtain relief from the automatic stay and enforce its collateral rights. 11 USC § 362(d)(1).

The Code describes certain nonexclusive means by which adequate protection can be provided, 11 USC § 361, but does not contain a statutory definition of "adequate protection." The

primary means for a debtor to supply adequate protection of a creditor's interest in its collateral are for the debtor (1) to offer periodic cash payments to the creditor to the extent that the stay results in a decrease in the value of the creditor's interest in its collateral, (2) to provide the creditor with an additional or replacement lien upon other property of the estate to the extent that the stay results in a decrease in the value of the creditor's interest in its collateral, or (3) to grant the secured creditor such other relief as will result in the creditor's realization of the "indubitable equivalent" of the value of the creditor's interest in its collateral. 11 USC § 361. In lieu of providing adequate protection, the debtor can seek to demonstrate that the value of the collateral greatly exceeds the amount of the secured creditor's debt. The excess collateral value is often called an "equity cushion" in the collateral. In such cases, many courts will not award any additional adequate protection to the oversecured creditor. The common theme in all these
10 approaches, however, is that the debtor must offer assurance to the secured creditor that the lien value of its collateral will be realized in full upon confirmation of a reorganization Plan.

If a grant of adequate protection ultimately proves to be "inadequate," the secured creditor's claim for its lost collateral value will be treated as a "super priority" claim and expense of the case. 11 USC § 507(b).

F. Controls on Debtor's Chapter 11 Operations.

In a Chapter 11 reorganization case, the debtor is automatically authorized to operate its business without specific court approval. 11 USC § 1108. Ordinarily, existing management personnel remain in place and run the company (in the case of fraud or gross mismanagement, a trustee can be appointed to take over the affairs of the business, but it is not common). In any event, the conduct of the debtor's business operations is subject to certain constraints under the Code.

1. Use, sale or lease of property of the estate.

The debtor may use, sell or lease most of its property in the ordinary course of business without special authorization from the bankruptcy court. 11 USC § 363(c)(1). However, certain items require special review and approval: the use of "cash collateral"; and the use, sale or disposition of any property outside of the ordinary course of business.

Cash collateral receives special treatment under the Code. It is comprised of cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents, including cash proceeds from other collateral, which serve as collateral for a claim. 11 USC § 363(a). The debtor may not use cash collateral without court authorization, unless the secured party consents. 11 USC § 363(c)(2). When the secured party does not consent, the use of the cash collateral by the debtor is prohibited unless the secured creditor is provided with adequate protection.

The sale of property outside of the ordinary course of business (i.e., sale of property which is not inventory) requires court approval. Such sales are often pursued to raise cash by disposing of nonessential assets, and are typically approved if the assets do not comprise a significant portion of the company's business and the terms of sale are fair. If the property is subject to security interests, it nevertheless can be sold "free and clear" of the security interests if the secured creditors consent, or other statutory criteria are met. In such case, the security interests are usually transferred to the proceeds of the sale, 11 USC § 363(f). If the debtor attempts to sell a substantial portion of its property outside of a Plan, it must articulate some business justification why such a major transaction ought to be allowed on an emergency basis.

2. New credit.

A Chapter 11 debtor may continue to obtain unsecured credit and incur unsecured debt in the ordinary course of business (e.g., postpetition trade debt) unless the court orders otherwise. Credit so obtained will be entitled to priority over all prepetition unsecured claims as an administrative expense. 11 USC § 364(a),

If the debtor is unable to obtain sufficient unsecured credit, the court, upon a showing of cause, may authorize the debtor to obtain credit or incur debt with a "super-super priority" over all administrative expenses, may grant to the new lender a lien on unencumbered property of the estate, or may grant a junior lien upon property that is already subject to a lien. 11 USC § 364(c). In special circumstances, the court may grant the new lender a lien with priority senior or equal to that of any existing lien upon a showing that the estate is otherwise unable to obtain sufficient credit and that the interests of the existing holder of the collateral will be adequately protected. 11 USC § 364(d).

12 **3. Status of executory contracts and leases.**

The Code provides the debtor with tremendous flexibility regarding certain types of ongoing agreements. The Code contains no precise definition of an "executory contract." As a general matter, an executory contract is a contract as to which material performance remains due on both sides (for instance, ongoing leases or supply agreements). Executory contracts can be assumed and performed by the debtor, assigned to a third *party* (in most cases), or rejected. 11 USC § 365.

By assuming (or assigning) a contract, the debtor binds itself (or its assignee) and all other contracting parties to perform the contract fully in accordance with its original terms, while rejection of a contract relieves the debtor from any further obligations to perform its contractual duties. Subject to certain exceptions, the debtor may assume, assign to a third party, or reject any executory contract or lease with the court's approval. Given this flexibility, the debtor's decision will usually depend on what makes the most business or financial sense, in the eyes of the debtor, for the business reorganization.

If the debtor should choose to reject an executory contract or lease, it will be deemed to be a breach of the contract effective immediately prior to the commencement of the case. This relieves the debtor from performance under the contract and gives the nondebtor party the right to contractual damages as a general unsecured claim. 11 USC § 365(g). Pending a decision to assume or reject an executory contract, the debtor has a right to enforce performance of the contract by all other parties to the contract. Following a decision to reject, the value conferred upon the estate postpetition via performance of the contract by the other party pending the debtor's decision to assume or reject is allowable against the estate as an administrative claim. See 11 USC § 503(b). In the case of rejection of a lease of non-residential real estate, however, special rules will apply.

A debtor must obtain court approval in order to assume or assign a contract or lease. 11 USC § 365(a). In situations where there is an existing default, the debtor cannot assume or assign the contract or lease unless the debtor cures the default, compensates the nondebtor party for actual pecuniary loss resulting from the default, and provides adequate assurance of future performance under the contract or lease. If a debtor's prospects for reorganization are poor, the court will not allow an assumption of a contract or lease. By assuming the contract (and/or assigning the contract to a third party), the debtor (or the assignee) and all other contracting parties remain bound by the terms of the original agreement.

As a general rule, but with an important exception for most commercial real estate leases, 11 USC § 365(d)(3), a debtor is not obligated to make the decision to assume, assign or reject until the confirmation of a Plan. A party bound under a contract or lease with a debtor may, however, move that the court establish a date certain on or prior to which the debtor must either assume, assign or reject the contract or lease. It is within the court's discretion whether to grant such a motion. For public policy reasons, the Code contains special provisions that deal with certain types of executory contracts, including leases of commercial real estate, shopping center leases, certain aircraft leases, agreements for the sale of timeshare interests in real property, and collective bargaining agreements. Although each special provision is different, the general effect of each set of rules is to restrict the debtor's rights and increase the protections afforded to the nondebtor party to the contract.

Generally, any clause providing that insolvency or bankruptcy shall be an event of default creating a right of termination or modification of the contract or lease (a so-called "ipso facto clause") is not enforceable in bankruptcy. There are exceptions to this rule, however, if the
14 contract is one to extend a loan or financial accommodation to the debtor, to issue a security on the debtor's behalf, or to perform uniquely personal services (such as a music recording contract), II USC § 365(e). Clauses prohibiting the assignment of a contract are similarly unenforceable in bankruptcy, with certain exceptions. 11 USC § 365(c), (f).

III. THE PLAN PROCESS AND REORGANIZATION

A. Assertion of Claims.

1. Schedules and proofs of claim.

The debtor is required to file schedules listing all of its creditors and shareholders. If a particular claim is described as "disputed," "contingent" or "unliquidated," then "proof" of the claim must be filed by the creditor in order to preserve its rights. Otherwise, the creditor need not file a separate "proof of claim" (unless it disagrees with the amount of the claim as listed, or if the Chapter 11 case is converted to a Chapter 7 case). 11 USC § 1111(a). If a proof of c [aim needs to be filed, it must be filed prior to the "bar date" established by the court (i.e., last date by which proofs of claim will normally be accepted). In large cases, the bar date is commonly set by the court for six months or more after the filing of the petition and often coincides with the dates of major hearings in the case regarding Plan confirmation.

All creditors and shareholders are entitled to receive advance notice of the bar date. Unless the claim is properly listed in the debtor's Chapter 11 schedules, the normal effect (with certain very limited exceptions) of an unsecured creditor's failure to file a timely proof of claim is for the claim to be disallowed (i.e., unenforceable in the bankruptcy proceedings, yet discharged like all other debts).

Questions of scheduling aside, creditors generally assert their claims by filing a "proof of claim." A proof of claim is a written statement setting forth the nature and amount
15 of the creditor's claim against the debtor. Such proofs of claim usually follow the form prescribed in the Bankruptcy Rules and attach the relevant supporting documentation such as the written contract or Note, or evidence of a perfected security interest.

A holder of an equity interest in the debtor may file a "proof of interest," which is roughly analogous to a proof of claim for an equity interest in the debtor. Because the schedule of equity security holders filed by the Chapter 11 debtor is often sufficient evidence of the validity and amount of shareholder interests in the debtor, it is often unnecessary for holders of equity securities to file proofs of interest.

2. Secured and unsecured claims.

A claim that is not secured by collateral is called an "unsecured claim." If a creditor's claim is secured by a lien on the debtor's property, it is a "secured claim" to the extent of the value of the collateral. If the value of the collateral is less than the debt, then the balance of the debt will be separately treated as an unsecured claim. 11 USC § 506(a).

To the extent the value of a secured creditor's collateral is greater than the amount of its secured claim, the creditor can also recover postpetition interest (usually at the contract rate) and its reasonable expenses (including attorneys' fees) to the extent provided for in the agreement giving rise to the security interest. 11 USC § 506(b). Conversely, the debtor may recover from a secured creditor's collateral reasonable and necessary costs of preserving the collateral for the benefit of *the* secured creditor. 11 USC § 506(c). Postpetition interest generally is not recoverable in respect of an unsecured claim unless the debtor is solvent.

3. Setoff claims.

Under state law, a creditor and debtor may set off claims arising from mutual debts. As a general matter, setoff rights are also recognized under the Code, but are subject to the further
16 limitation that both debts to be set off must be prepetition in origin. 11 USC § 553. In effect, the amount that might be set off by the creditor is treated as a secured claim since it offsets, dollar for dollar, the amount of any claim that the debtor has against the creditor.

The Code, however, sets certain limitations on setoffs. 11 USC § 553(a), (b). These limitations provide, in part, that a debtor may avoid the amount of any prepetition setoff that exceeds certain amounts available for setoff during the ninety days prior to the bankruptcy filing. The purpose of this rule (like "preferences" discussed below) is to take away any undue advantage gained by a creditor who sets off a claim shortly before the bankruptcy of the debtor.

4. Priority claims.

After payment of secured claims, certain unsecured claims are entitled to payment priority over others. These are claims that Congress deemed to be essential to the conduct of the case itself, or deserving of special treatment out of fairness to the claimants. Even within the general group of priority claims, certain priorities are higher than others. "Super-super priority claims" for new credit (discussed above), "super priority claims" for "inadequate protection" (discussed above), and claims for "administrative expenses" are the first to be paid when a distribution occurs pursuant to a Plan. 11 USC §§ 364, 507. Administrative expenses include (1) the actual, necessary costs and expenses of preserving the estate (including postpetition wages, salaries and trade payables), (2) postpetition taxes incurred by the estate, and (3) fees and expenses of professional persons employed in the case. 11 USC § 503. Finally, certain other claims (e.g., claims for certain prepetition taxes, wages and employee benefits) are entitled to payment after administrative claims but before "general" unsecured claims. 11 USC § 507.

5. Attorneys' fees.

17 If their contracts allow, creditors may add their reasonable collection costs, including attorneys' fees, to the amount of their general prepetition secured and unsecured claims. Creditors who are "oversecured," i.e., the value of their collateral exceeds the amount of their claim, are normally allowed to recover their reasonable attorneys' fees to the extent of the excess collateral value. 11 USC § 506(b). On the other hand, except in unusual circumstances, unsecured and undersecured creditors normally cannot obtain priority status for their collection costs.

B. The Plan Process.

1. Who may file a Plan.

The debtor has the exclusive right to propose and file a Plan during the first 120 days after the commencement of the case. 11 USC § 1121(b). The 120-day period is called the debtor's "exclusivity period," and it is often extended by the court for "cause." 11 USC §

1121(d). The 120-day exclusive period can be reduced or extended "for cause," but cannot be extended beyond a date 18 months following the commencement of the Chapter 11 case. 11 USC § 1121(d)(2)(A).

A creditor may file a flan only if the debtor's exclusive period for filing (or obtaining consent to) a Plan has expired or been terminated by the Bankruptcy Court, or if a trustee has been appointed in the case. 11 USC § 1121. In larger Chapter 11 cases, fights over extending or terminating the debtor's exclusivity period are often hotly contested by creditors who want to file their own Plan. A party who has the ability to file a Plan can greatly influence the direction of the Chapter 11 case.

2. Elements of a Chapter 11 Plan.

A Plan may provide for comprehensive changes in the financial and business structure of the debtor, including sales of assets, cancellation of debt, curing or waiving of defaults, satisfaction or modification of liens, amendment of the debtor's corporate charter, changes in the amount, interest rate or maturity of outstanding debt, and issuance of new debt or equity securities of the debtor in replacement of existing claims and equity interests.

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. Plans with repayment periods of up to 20 years have been confirmed by the courts. A Plan can cancel existing shareholder interests, provide for the issuance of new equity securities, or convert debt claims into equity interests in the reorganized company.

Of late, bankruptcies have been viewed by investors and corporate raiders as a forum for accumulating control securities at bargain prices and for influencing the corporate governance of a debtor. Articles of incorporation can be changed in a Plan to change the voting rights of different issues of shares, and implement or modify anti-takeover measures.

After a disclosure statement has been approved (discussed below), the Plan is submitted to a vote by all creditors and shareholders who are adversely affected by its terms. The determination of whether a Plan has received a sufficient number of votes is governed by complex rules discussed below. If certain conditions are met, a Plan can be imposed on a creditor (or sometimes the debtor) even if certain parties object. The ability to impose a comprehensive financial restructuring is one of the primary benefits of Chapter 11, and encourages the parties to negotiate a consensual plan acceptable to all parties-which is often faster and cheaper than extensive litigation over the Plan.

3. Classification of claims and equity interests.

For purposes of voting and treatment under a Plan, claims and equity interests must be
19 grouped into one or more "classes," depending on their nature. 11 USC § 1123(a)(1). By law, claims may be placed in a particular class only if the other claims in the class are "substantially similar," and the Plan must provide the same treatment for each claim or equity interest in a particular class. 11 USC § 1122(a), 1123(a)(4). Classification is important because a Plan must be separately voted upon by each class of creditors and shareholders.

As a general rule, each secured claim is placed in its own special class, while all general unsecured creditors are ordinarily placed in the same class. Shareholders are placed in still different classes such as holders of "preferred" or "common" stock.

Some courts will approve classifications which place unsecured creditors in separate subclasses, reasoning that the financial interests of the separately classified creditors are sufficiently different to warrant separate class voting on the Plan (i.e. the claims of retirees for future benefits). In such cases, the courts will evaluate whether the classification scheme discriminates unfairly or is proposed in bad faith.

4. The requirement of adequate disclosure.

The Code requires that, before voting on a Plan, holders of claims and equity interests must receive a court-approved disclosure statement containing "adequate information" concerning the debtor and the Plan. 11 USC § 1125. In general, information is adequate if it would enable a hypothetical investor to make an informed judgment about the treatment of its claim or equity nterest under the Plan. The disclosure statement need not comply with formal securities law disclosure requirements.

5. Voting on the Plan.

Only classes of creditors or shareholders having claims or equity interests that are "impaired" under the Plan (i.e., paid less than full or otherwise modified) are entitled to vote on
20 the Plan. 11 USC § 1126. Each holder of a claim or equity interest votes on the Plan with other members of the applicable class. Acceptance by a class of claims requires consent by holders of claims equaling at least two-thirds in amount and a majority (more than one-half) in number of the claims in the class that are actually voted. 11 USC § 1126(c). A class of impaired equity interests will be found to have accepted a Plan upon the vote of holders of two-thirds of the allowed amount of such interests. 11 USC § 1126(d). Frequently, classes of claims or interest recovering no distribution under the Plan are deemed to reject the Plan, and are not even solicited.

6. Basic tests for confirmation.

The bankruptcy court is required by the Code to make a number of specific findings to "confirm" (approve) a Plan and make it binding on all parties. 11 USC § 1129(a). These include determinations that the Plan complies with all applicable law and has been proposed in good faith. The 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 and objects to its confirmation, then the Plan must also pass the "Best Interests of Creditors Test" discussed below. If a class of creditors votes to reject the Plan, the Plan can nevertheless be imposed on the class ("crammed down") if the Plan passes the "Fair and Equitable Test" discussed below.

7. "Best Interests of Creditors Test" for an objecting creditor or shareholder.

As noted above, whether a holder of a claim or equity interest may vote on a Plan depends upon whether the holder's rights are impaired under the Plan. Such voting is done by each class of impaired claims or equity interests. Even if all classes entitled to vote on the Plan have voted to accept the Plan, the court must still determine whether the Plan is in the "best interests" if there are any individual dissenting creditors or shareholders. 11 USC § 1129(a)(7). This rule is called the "Best Interests of Creditors Test" and 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 of the Code. 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. If the court determines that the distribution under the Plan is equal to or more than the holders would have received in Chapter 7, then the reorganization of the debtor as a going concern is in the "best interests of creditors" because they will receive at least as much as they would have received had the business been shut down and liquidated. In such case, a minority voter in an impaired class cannot be heard to complain about its treatment under the Plan.

8. Cramdown of an objecting class under the "Fair and Equitable Test."

If an impaired class votes, as a class, to reject the Plan, the Plan can nevertheless be imposed ("crammed down") on the entire objecting class if (1) at least one impaired class has voted to accept the Plan and (2) the court finds that the treatment provided for the objecting class under the Plan does not "discriminate unfairly" and is "fair and equitable" (the "Fair and Equitable Test"). 11 USC § 1129(b)(1).

The prohibition against "unfair discrimination" means that, ordinarily, similar claims or equity interests must be treated similarly. 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) the secured creditors in the class will retain a lien to the extent of their secured claims and will receive deferred cash payments which have a present value equal to at least the value of their interest in the collateral, (2) for the sale of the secured creditors' collateral with the creditors' security interests attaching to the proceeds, or (3) for the realization by the secured creditors of the "indubitable equivalent" of their secured claims. 11 USC § 1129(b)(2)(A). 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 value of their security interests in the collateral.

The Fair and Equitable Test for unsecured creditors and for shareholders is much simpler-at least from a legal perspective. 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 full unsecured claims (i.e., payment in full), or if creditors in the Plain are not recovering (over time) payment in full that at least classes junior to the class in question (such as subordinated creditors or stockholders) receive nothing under the Plan. 11 USC § 1129(b)(2)(B). Equity security holders can be crammed down along similar lines. 11 USC § I129(b)(2)(C). This test is also sometimes referred to as the "absolute priority rule" meaning, as a general matter, that junior classes cannot receive anything unless and until senior classes are paid in full, or voluntarily agree to different treatment as part of a consensual plan. The basic priority of classes is the same as non-bankruptcy: secured claims first, unsecured
23 claims second, and equity interests last.

Secured and unsecured creditors alike have something to risk and gain in a cramdown. Secured creditors may retain a security interest only up to the value of their collateral the balance is unsecured. Unsecured creditors might receive little more than liquidation values -- but they can also block the shareholders from receiving anything. Equity puts the corporate control and ownership of the company at risk -- but can also retain any true equity values over and above full recoveries by senior classes. In each case, a subjective determination by the bankruptcy court of the reorganization value of the company or its property is an essential ingredient to imposing a cramdown Plan. Valuation proceedings can be risky, expensive and difficult *to* overturn on appeal. Hence, given the litigation risks over valuation, and the "bottom line" risks and benefits of cramdown, the Code artfully encourages the parties to negotiate a consensual plan rather than take their chances in court.

9. Pre-packaged Bankruptcies

Often the Debtor will coordinate with major creditor groups prior to commencing a chapter 11 case and work out a consensual reorganization plan ahead of time. These types of plans are often referred to as "Pre-packaged plans" and the Debtor will file the pre-negotiated plan with the court on the first day, as well as votes confirming the plan. In this situation, Bankruptcy Code section 341(e) will allow a court to dispense with a meeting of creditors. Additionally, section 1125(g) will allow for the continued post-filing solicitation of votes on a plan, without regard to approval of the disclosure statement, if the solicitation complies at the time, and if the pre-filing solicitation complied, with applicable nonbankruptcy law.

IV. <u>SPECIAL POWERS OF THE DEBTOR IN POSSESSION OR TRUSTEE</u>

24 The Code strives to treat similarly situated creditors equally and to take away any undue advantage gained by one creditor over another regarding a distressed business. One of the methods used to achieve this goal is to scrutinize several types of prepetition or postpetition transfers of cash or other property, or the incurrence of certain debts or guaranties. In some circumstances, such transfers or obligations can be rendered null and void, or subordinated to the claims of other creditors, on a variety of grounds. These grounds are not mutually exclusive and each can possibly apply to any given set of facts.

A. Strong Arm Powers.

The debtor is vested with the legal power to avoid liens, transfers and obligations that under applicable bankruptcy law (usually state law) would be deemed to be junior in right to various "hypothetical lien creditors." The "hypothetical lien creditors" against whom the rights of others are measured are: a judicial lien creditor obtaining a lien on all property of the debtor as of the commencement of the case; a creditor extending credit and obtaining an execution against the debtor that is returned unsatisfied; and a bona fide and perfected purchaser of real property as of the commencement of the case. 11 USC § 544(a). While sounding quite technical, the debtor's status as a "hypothetical lien creditor" allows it to "wipe clean" any liens, claims or transfers that are legally inferior under state law. This special legal status is called the debtor's "strong arm powers."

The debtor's strong arm powers are most commonly exercised when a secured creditor has failed to take the appropriate steps under state law to properly perfect its lien, or when a previously-perfected security interest has lapsed due to the creditor's failure to file a "continuation statement" required under state law. In such circumstances, the debtor can exercise its strong arm powers to avoid the secured creditor's unperfected interests in the
25 debtor's property.

B. Preferences.

Generally speaking, a "preferential transfer" is a transfer of the debtor's property to, or for the benefit of, a creditor within 90 days prior to the commencement of the bankruptcy (one year if the creditor is an "insider") that gives the creditor a benefit not shared by other creditors. Subject to certain exceptions (primarily concerning transactions in the ordinary course of a debtor's business or in which a debtor receives "new value" in exchange for the transfer), the debtor can "avoid" (i.e., cause to be undone) a preferential transfer and recover the transferred property for the benefit of the estate. 11 USC § 547.

Typical examples of preferential transfers include the late payment of a trade debt, the granting of a security interest to a previously unsecured or undersecured lender, and delayed perfection of a security interest granted by the debtor contemporaneously with the incurrence of debt.

C. Fraudulent Transfers.

The Code includes a provision enabling the debtor to avoid under federal bankruptcy law any transfer by a debtor occurring within two year of the debtor's bankruptcy filing (1) made with actual intent to hinder, delay, or defraud its creditors, or (2) for which the debtor received less than "reasonably equivalent value" at a time when the debtor was either insolvent on a balance sheet basis (either before, or as a result of, the transfer), was left with unreasonably small capital for engaging in its business or was unable to pay its debts as they became due. 11 USC § 548. Examples of potential fraudulent transfer situations include nonjudicial foreclosures on real estate when the property is sold at a distressed sale bargain price, and many (but not all) "up-stream" and "cross-stream" guaranties.

26 The debtor can also invoke certain state laws to avoid transfers of assets, such as state fraudulent conveyance and bulk transfer laws, where harm to an actual unsecured creditor can be shown. 11 USC § 544(b). A significant benefit in bringing an action under state law is that the statutory period for limitation of actions is generally longer. For example, the "lookback" period for fraudulent transfers under state law is often between three and six years, while it is only one year under the Code.

D. Contractual and Equitable Subordination.

The Code expressly provides for the enforceability of valid contractual subordination provisions. 11 USC § 510(a).

In addition, claims can be "equitably subordinated" to other claims when the holder of the challenged claim engaged in "inequitable" or "improper" conduct. The purpose of equitable subordination is to adjust the priority of the creditors' claims rather than to effect a total disallowance of the subordinated claim, although total disallowance is possible under exceptional circumstances. 11 USC § 510(c).

For instance, transactions involving creditors who are found to have "controlled" the debtor (either intentionally or inadvertently) are subject to strict examination, and may lead the court to subordinate the claims of the controlling creditor. Equitable subordination commonly becomes an issue when debt claims are held by entities that are also major shareholders of the debtor (on the theory that the "debt" was more in the nature of a "contribution to capital" than a "true" debt). Debtors occasionally also seek to subordinate the claim of their major prepetition lender on the ground that the lender exercised improper control over the operation of the business or improperly denied credit, declared defaults or enforced remedies, thereby causing damage to the estate and its creditors. Such conduct can
27 also give rise to an affirmative claim for damages against the lender under theories of "lender liability."

It should be emphasized, however, that while threats of equitable subordination are often made, it is a remedy seldom ordered by bankruptcy courts.

E. Recovery of Unauthorized Postpetition Transfers.

With certain statutory exceptions (e.g., a transfer approved by the bankruptcy court), the debtor may avoid any postpetition transfers of property outside of the ordinary course of the debtor's business because such transfers, if permitted, would cause fewer assets to be available to pay the claims of creditors. 11 USC § 549. An action to recover improper postpetition transfers must be commenced within the earlier of two years after the transfer occurred or before the case is closed or dismissed.