

## Bankruptcy II Outline

I. **OVERVIEW.** “Chapter 11 is an opportunity and invitation for negotiation and compromise.” The main purpose of chapter 11 is to capture the going concern value of the business. Generally, business entities are worth more as a going concern rather than as the sum of the liquidated pieces. If profitability can be restored, then the reorganized business will be an engine from which to pay more to the creditors. To that end, a debtor who files for Chapter 11 wants to reorganize its debt by extending the time in which to pay and reducing the total amount to be paid. The business continues to operate in the “ordinary course,” §363(c), under control of the DIP.

A. **Petition.** The petition can either be voluntary or involuntary. It can be either for reorganization or liquidation. When the petition is filed, the debtor is also required to file schedules, a statement of affairs, and a list of the twenty largest unsecured creditors (used by the US Trustee to select a committee of creditors).

B. **Automatic Stay.** When a debtor files a petition, the §362(a) automatic stay is imposed, which prohibits any creditor’s attempt to collect a debt, foreclose, or otherwise assert dominion over property of the bankruptcy estate, or continue to collect a debt if the collections began before the petition. The stay is nationwide or even worldwide), comes into effect automatically and instantly, and does so by operation of law *ex parte*. Actions taken in innocent violation of the stay, without notice of the bankruptcy filing, are void or voidable.

i. Relief from Stay: §362(d). Relief from stay can mean terminating, annulling, modifying, or conditioning the stay. It can be granted for the following reasons.

1. For cause: this includes lack of adequate protection and bad faith.
2. Lack of Equity: property in which the debtor has no equity when the property is not necessary for an effective reorganization. The debtor has the burden to show that the reorganization can be done in a reasonable amount of time.
3. SARE: a SARE has 90 days after the petition or 30 days after the court determines that the case is a SARE to either file a plan that has a reasonable possibility of being confirmed with a reasonable time, or make payments in an amount sufficient to give present value equal to the secured creditor’s security interest (interest). Payments may be made out of rents generated by the property, but the interest can be the contract rate of interest.
4. Fraud: with respect to real property when the petition is part of a scheme to delay, hinder, and defraud creditors that involved either the transfer of ownership in real property without the consent of the secured creditor or the court, or multiple bankruptcy filings affecting the property.

*Purpose* – The stay prevents the dissipation or diminution of the debtor’s assets while rehabilitative efforts are undertaken. *Farm Credit of Central Florida, ACA v. Polk*.

The stay prevents certain creditors from gaining a preference for their claims against the debtor and, in general, avoids interference with the orderly liquidation or rehabilitation of the debtor. *Id.* The purposes of the automatic stay are to protect the debtor's assets, provide temporary relief from creditors and promote equality of distribution among the creditors by forestalling a race to the courthouse. *Id.*

*Nondebtors* – The automatic stay stays actions against the debtor, but not for nondebtors, even nondebtor codefendants. *Untied States v. Seitles*. However, a court may exercise its equitable powers under §105 to extend the stay to a nondebtor when the action against the nondebtor is so inextricably interwoven with the affairs of the debtor that it would substantially hinder the debtor's rehabilitation effort. *Id.*

- C. **Claims.** The definition of “claim” is extraordinarily broad, encompassing not only all current obligations, but any “right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured.” §101(5)(A).

*Claims Trading* – Creditors are sometimes allowed to buy claims of other creditors. Such purchases, though, may result in a violation of §1126(e), which provides that the court may designate any entity whose acceptance or rejection of a plan was not in good faith. Designate means disqualify from voting. *In re Figter LTD*. A single, large creditor is not the only one that may be interested in buying the claims of creditors in bankruptcy cases. Outside investors, people who had no special connection to the company before the bankruptcy filing, may want to buy the claims of creditors in a reorganization proceeding. This process of buying bankruptcy-based obligations is known as claims trading.

- A. Ulterior Motive. Whether a purchaser of claims will be allowed to vote on such claims will depend on the motive of the purchaser. A creditor is permitted to protect its position in the case as a claimant, and is even permitted to purchase claims in order to influence the voting of various classes. However, a creditor may not purchase claims and influence voting if the purpose for doing so is to gain an advantage in the marketplace outside of the bankruptcy case.

*In re Figter, LTD* – A bad faith ulterior motive for purchasing claims is not allowed. Some examples include pure malice, strikes and blackmail, or to destroy an enterprise in order to advance the interests of a competing business. Courts see the purchase of a claim by a stranger to the bankruptcy as an indication of bad faith, or where the purchaser is associated with a competing business of the debtor. Further, the purchase of claims by an insider or affiliate for the purpose of blocking or fostering a plan is seen as a badge of bad faith. It is necessary to keep in mind the difference between a creditor's self-interest as a creditor and a motive that is ulterior to the purpose of protecting a creditor's interest.

*Regulatory Claims* – The question has arisen whether a governmental regulatory agency is like any other creditor, or whether its status as a regulatory agency permits it to use its administrative powers to trump and derails the debtor’s efforts in bankruptcy. The court in *FCC v. Nextwave Personal Communications* held that the FCC was not allowed to revoke a license needed by the debtor to operate if the FCC’s sole reason for doing so was a failure to pay the dischargeable debt.

*Estimation of Claims: §502(c)* – The judge has the power to estimate the value of elusive and uncertain liabilities. §502(c) says that there shall be estimated for purpose of allowance of claims (1) any contingent or unliquidated claim, the fixing or liquidation of which, as the case may be, would unduly delay the administration of the case; or (2) any right to payment arising from a right to an equitable remedy for breach of performance. Some particularly troublesome claims are discussed below. The central issue with the below types of claims is timing: when does the claim arise?

- i. Environmental Claims. The principal timing difficulty with environmental claims is that the obligations tend to cover both pre- and post-filing period. Additionally, there is a question about whether portions of such claims that arise post-petition are discharged by the bankruptcy. There is no definitive answer to these questions.

*Fair Contemplation/Foreseeability* – This standard for determining when an environmental claim arises for the purpose of bankruptcy discharge says that such a claim arises pre-petition only if it is based upon pre-petition conduct that can fairly be contemplated by the parties at the time of the debtor’s bankruptcy. Under this standard, a claim arises pre-petition when the claimant could have ascertained through the exercise of reasonable diligence that it had a claim against the debtor at the time the bankruptcy was filed. Look to factors such as notice, existence of an asserted claim, and underlying acts that have been completed in answering this question. *Signature Combs, Inc. v. United States*.

- ii. Mass Torts. Courts need to decide in mass tort situations whether they can find a legally acceptable way to represent future claims that are contingent and unmaturred so as to resolve these claimants’ rights in the bankruptcy. The same timing issue that arose in environmental claims arises again here.

*Standing: Kane v. Johns-Manville Corp.* – The court held that Kane, an asbestos claimant, did not have standing to assert the rights of future asbestos claimants in attacking the plan because Kane’s interest in the proceedings was potentially opposed to that of the future claimants. Further, the third parties whose rights Kane sought to assert were already represented in the proceedings by an appointed legal representative, and this representative expressly stated that he did not want Kane to assert the future claimants’ rights. Also, Kane’s interests were not so “inextricably bound up with” those of the future claimants in such a suit as to warrant third-party standing.

*Legal Representative* – A legal representative is one device for assuring fundamental fairness for future mass tort claimants. A non-party could be bound to a prior judgment when the non-party's interests have been represented in the proceeding by a person with similar rights or interests, or when the issues resolved in a prior suit where the non-party's interests were so closely aligned with the interests of a party that the non-party's interests can be held to be virtually represented.

- iii. Future Claims. The issue of future claimants arises out of the sale of assets free and clear. Prospective purchasers of the debtor-business or many of the debtor's assets often wish to obtain the assets free and clear of all current and future claims. When such a transaction is completed, the court may have to face the issue of a post-petition arising claim. In *In re Fairchild Aircraft Corp.*, such a sale occurred, but after the confirmation, an accident occurred that resulted in a lawsuit against the reorganized company. The court had to face the issue of whether such a claim was barred by the sale free and clear, and the subsequent bankruptcy discharge. A legal representative (above) may be able to solve this problem.

*Relationship/Conduct Plus Test* – The court in *Fairchild* applied this test, which looks to whether the purported claimant had a specific and identifiable relationship with the debtor pre-petition. The court inquires into the relationship between the debtor and the claimant. The court will find that the claim existed pre-petition, and thus is barred from post-petition suit as a result of the sale free and clear and discharge, when some pre-petition relationship between the debtor's pre-petition conduct and the claimant is established. Some examples include contact, exposure, impact, and privity between the claimant and the debtor.

*Litigation Trust* – A plan will sometimes provide that an escrow of money or property will be held in trust pending the resolution of litigation. Such trusts can be used to deal with the problem of future claimants, especially in mass tort cases. A plan might provide that if it turns out that the money is not needed to fund the result of future litigation, then the assets in the trust will be distributed to pro rata to unsecured creditors (or something similar to that).

## II. PARTIES.

- A. **Debtor in Possession (DIP)**. The DIP controls the new legal entity created by the filing of the petition (called the estate). The DIP has most of the legal rights and duties of a TIB. §1107. The DIP has fiduciary duties. *Id.* The DIP is usually the management of the debtor.

*Avoiding Powers* – The DIP has “avoiding powers,” including the power to recover preferences, the power to assume or breach outstanding executory contracts, the

power to void fraudulent conveyances, the power to set aside unperfected or late-perfected security interest in the debtor's property, and the power to require turnover of property being held by another entity.

*Employment of Professionals* – The DIP may employ professionals such as attorneys, accountants, appraisers, and auctioneers so long as the professional does not hold or represent an interest adverse to the estate, subject to getting a court order. §327(a). The court may retroactively alter the terms of engagement of such the professional.

*Rebuttable Presumption* – There is a presumption that the management of the debtor knows the business of the debtor the best and is therefore in the best position to serve as the DIP. This presumption is rebuttable, as when a trustee or examiner is appointed.

- i. Appointment of Trustee. The appointment of a trustee should be the exception, rather than the rule. The court in *In re Sharon Steel Corp.* appointed a trustee because it found large-scale waste and diversion of corporate assets. The court in *In re Rush* did not appoint a trustee even though there was a suspicion that fraudulent conveyances and concealment of assets existed. Thus, it is difficult to get a trustee appointed. See §1106(a) for the trustee's duties.

*Grounds* – A trustee can be appointed for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the debtors affairs, either before or after the commencement of the case, or similar cause. A trustee may be appointed if such an appointment is in the interests of creditors, any equity security holders, and other interests of the estate. A trustee may be appointed if grounds exist to convert or dismiss the case under §1112, but the court determines that the appointment of a trustee or an examiner is in the best interests of the estate.” §§1104(a)(1)-(3). BAPCPA added §1104(e), which says that the U.S. Trustee shall move for the appointment of a trustee if there are “reasonable grounds to suspect” that those currently in control of the business participated in actual fraud, dishonesty, or criminal conduct as they managed the debtor or made financial reports.

- ii. Appointment of Examiner. An examiner is appointed to investigate the affairs of the debtor, including identification of pre-bankruptcy fraud and mismanagement, discovery of causes of action, and monitoring of the debtor's past and present activities. An examiner has no management role, unless he is given this power by the court. He cannot become a trustee should one be appointed. See §1106(b) for the examiner's duties, which are to be granted or limited in scope at the discretion of the court.

*Grounds* – If the court does not order the appointment of a trustee, then the court can order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any

allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor if (1) such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, or (2) the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed \$5,000,000. §1104(c). The Bankruptcy Court has no discretion to deny appointment of an examiner where the \$5,000,000 debt threshold is met. *In re Loral Space & Communications*.

- B. Committee of Unsecured Creditors (Committee).** The committee is appointed by the US Trustee and ordinarily consists of the seven largest creditors in a class of those willing to serve. It operates as a powerful voice on behalf of the unrepresented unsecured creditors because most individual unsecured creditors do not have enough at stake personally to take the time and expense necessary to monitor a case. There can be multiple committees in a single case, including a committee of equity holders. §1102.

*Duties* – The committee scrutinizes the debtor's activities on behalf of all creditors in the same class. §1102. It also negotiates with the debtor on behalf of all creditors in the same class. *Id.*

*Attorney's Fees* – The attorney's fees for the committee are administrative expenses that must be paid by the debtor in cash in full on the effective date.

*Small Business Case* – In a small business cases, a party in interest may request that no committee be appointed. "Small business case" is a defined term, and is defined below.

*Changing Members* – Under BAPCPA, the composition of the committee may be changed after notice and hearing when it is necessary to ensure adequate representation of creditors or of equity. §1102(a)(4).

- C. Secured Creditors.** A secured creditor has a security interest in property of the debtor. Such a creditor is chiefly interested selling its collateral and collecting the proceeds, or, in the alternative, in adequate protection of its collateral.

- i. Adequate Protection. The debtor must provide protection against the secured creditor's anticipated loss of collateral value (called adequate protection). "Adequate protection" is not defined in §361, but some examples include: equity cushion, cash payments, replacement lien, and the "indubitable equivalent." If adequate protection is necessary, the debtor must provide enough to protect the creditor's anticipated loss of collateral value. The creditor has the burden to show that adequate protection is necessary.

*Relative Position* – Adequate protection must only be paid to prevent a decrease over time of the creditor's relative position. *United Savings Ass'n v.*

*Timbers of Inwood Forest.* In that case, the court explained that if the debt and the value of the collateral are the same, and the judge believes that the value of the collateral is stable or increasing, then no adequate protection payments must be made. This is because the creditor's relative position is not getting worse with the passage of time.

*Failure to Make Payments* – If the debtor cannot make the adequate protection payments, the creditor can request a relief from the automatic stay. Sometimes the court will determine that adequate protection payments must be made in an amount that is too high for the debtor's cash flow to cover. In such a case, the reorganization effort is usually over.

- D. **U.S. Trustee.** The U.S. Trustee reviews the monthly operation reports of the debtor, looking at every transaction that the business engaged in over the course of the month to see if there is a deepening insolvency problem. If there is a deepening insolvency, the trustee will become very active, often filing a motion to convert the case into Chapter 7.

### III. TYPES OF CHAPTER 11S.

- A. **Large Public Companies.** The central distinguishing characteristic of public companies is that, in most such companies, management is separated from ownership. This means that the ownership of the company is irrelevant to the success of the company, and also that the interests of management and ownership (shareholders) may be inconsistent.

*Zone of Insolvency* – A non-bankruptcy legal idea is that when the debtor enters the “zone of insolvency,” directors acquire a duty to creditors under state corporate law.

- B. **Small Business Cases.** §101(51D)(A) defines what a “small business case” is. A small business debtor is one that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition in an amount not more than \$2 million. Such businesses face increased reporting requirements, greater U.S. Trustee supervision, shorter delaines, and more drop-dead points at which they can be forced out of Chapter 11. A small business debtor hoping to take a second bite at Chapter 11 within two years of the first filing must prove to the court that its bankruptcy resulted from circumstances beyond the debtor's control that were not foreseeable at the time the case was filed and that it is more likely than not that the court will confirm a plan of reorganization. If the small debtor cannot make that proof, then there is no automatic stay available to protect the debtor. §362(n)(1)(D).
- C. **Single Asset Real Estate (SARE) Cases.** §101(51B) defines what a SARE is. “Single asset real estate” means real property constituting a single property or project, other than residential real property with fewer than 4 residential units, which generates substantially all of the gross income of a debtor who is not a family farmer and on which no substantial business is being conducted by a debtor other than the

business of operating the real property and activities incidental. A typical example would be a corporation or partnership whose only real asset is an apartment house or office building and whose only substantial debt is the mortgage on it. There is a shorter automatic stay in these cases: the debtor must start making payments after 90 days or file a plan that is likely to be confirmed. §362(d)(3).

- D. **Pre-Packaged Plans.** This term is used to describe a case in which the debtor has negotiated a deal with several or all of its creditors before filing a petition, but desires to take advantage of provisions in the Bankruptcy Code. The debtor can often forego the need for a separate disclosure statement so long as the debtor can show that the pre-petition disclosure was adequate. §1126(b) deems pre-petition votes to be effective in the bankruptcy proceedings so long as the pre-petition solicitation complied with all applicable disclosure laws and regulations. If there are no applicable SEC or similar laws, then the solicitations will be effective if they comply with §1125(a).
- E. **Auctions.** An auction may be held pursuant to a confirmed plan, but often it is not. When it is not, the sale is completed under §363 prior to any creditor vote. The plan is simply a mechanism for authorizing the auction and distributing the proceeds. In such a case, there will rarely be any meaningful recovery for equity.
- F. **Liquidation: §1123(b)(4).** Liquidation plans are often, but not always, associated with auctions and pre-packaged plan (above). The Code allows for the liquidation of a business under Chapter 11 because it is thought that the DIP can get a better price for the debtor's assets than can a trustee. Generally, a liquidating plan only requires that the assets be sold, disputes be resolved, debts be collected, and proceeds from sales be distributed according to an agreed upon formula.

**IV. POST-PETITION OPERATION.** The DIP retains control of the business and continues running it. He will begin to negotiate with creditors in an effort to come up with a confirmable plan.

- A. **General Dynamics.** The DIP serves the estate and all of the creditors, including equity. These various parties have different, often conflicting, goals. Equity will want visionary schemes that will turn the business around and pay everybody back in full, while secured creditors will want to liquidate. The DIP is held to a reasonableness standard, so while he may want to risk whatever money the estate has when there is a chance to pay everybody back, the DIP must act with prudence and reasonableness. The unsecured creditors want a slightly more conservative game plan than equity, but less conservative than the secured creditors. Often the DIP and the creditors will have disputes, and if such disputes become serious, the creditors may seek conversion of the case or appointment of a trustee.  
A secured creditor usually has a lot of leverage and can demand that certain things be in a plan. If such things are not in the plan, a secured creditor will often file for relief from stay, appointment of a trustee, oppose motions, vote no on the plan, etc. The committee has the power of the “yes letter,” and the threat of a “no letter.” In

addition to trying to form an alliance with one or more of these parties, the debtor must also keep an eye on administrative costs because all administrative claims must be paid in full in cash on the effective date or the plan cannot be confirmed.

**B. First Day Motions.** “First Day Motions” are a combination of customary procedural, administrative, and substantive motions made by the Debtor on the date of filing the petition in order to maintain normal operation of the business. They typically include a cash collateral motion, application for employment of professionals, critical vendor motions, payment of pre-petition wages, and payment of utilities.

- i. Cash Collateral: §363(c) and (e). Cash collateral is the proceeds from the sale of any secured property, or cash that a lender has a security interest in. Since it is highly volatile and subject to rapid dissipation, it requires special protective safeguards to assure the lien holder that it is not deprived of its collateral through unprotected use by the debtor. *In re Earth Lite*. The safeguards say that such encumbered cash cannot be used by the DIP without either the consent of the lien holder or a court order. Note that non-cash collateral may be used so long as it is used in the “ordinary course of business.” §363(c)(1).

*Adequate Protection* – In return for the authority or consent to use cash collateral, the DIP often must make adequate protection payments, including giving an additional or replacement lien to the secured party to compensate for the diminution of its cash collateral.

*Setoff: §553* – Sometimes a creditor will be allowed to offset a debt it owes to the debtor against a debt owed to the creditor by the debtor, but it must get court approval. *Citizens Bank of Maryland v. Strumpf*. A creditor with a right of setoff is treated as secured for the amount of its setoff right, §506(c), and the account subject to set off is treated as cash collateral under §363. To enforce a setoff right, the creditor must show that it has a right to setoff under nonbankruptcy law and that the right should be preserved in bankruptcy under §553. *In re Hal*. The creditor must show that the debts are in the same right and between the same parties, standing in the same capacity and same kind or quality. *Id.* Setoff may be denied, however, where setoff would jeopardize the debtor’s ability to reorganize or if the creditor has acted inequitably. *Id.* This often comes up in the case of banks. Debtors often keep a bank account with a bank that has lent money to the debtor.

- ii. Critical Vendors. Generally, pre-petition debt cannot be paid during the pendency of a bankruptcy case. However, some courts will allow an exception for critical vendors. The idea is that certain vendors are critical to the functioning of the business, so when such vendors refuse to work without being paid, the reorganization will fail unless the court allows payment. This is a controversial issue in bankruptcy.

iii. Pre-Petition Wages. This is the same issue as critical vendors, except it involves the pre-petition wages of employees. Payment of pre-petition wages is generally allowed.

C. **Utilities: §366.** Subsection (a) says that a utility may not alter, refuse, or discontinue service to the debtor solely on the basis of the commencement of a case or that a debt owed to such utility for service rendered before the order for relief was not paid when due. Subsection (b) says that a utility may alter, refuse, or discontinue service if the debtor, within 20 days of filing, does not furnish adequate assurance of payment in the form of a deposit or other security for service after the petition. Subsection (b) places on the debtor the burden to take an affirmative action (provide adequate protection without being asked). Subsection (c)(2) says that a utility in a chapter 11 case may alter, refuse, or discontinue any utility service, if during the 30 day period beginning on the date of the filing the utility does not receive from the debtor adequate assurance of payment for the utility service.

C. **Post-petition Financing: §364.** The DIP may obtain financing and other credit during bankruptcy with the approval of the court. The following are the ways under §364 that the DIP may obtain financing.

- (a) A DIP may obtain unsecured credit in the ordinary course of business as an administrative expense without a court order.
- (b) After notice and hearing, a DIP may obtain unsecured credit not in the ordinary course of business as an administrative expense.
- (c) If the DIP is unable to obtain financing by offering an administrative expense, he may obtain financing after notice and hearing by offering priority over all administrative expenses, a security interest in unencumbered property, or a junior security interest on encumbered property.
- (d) If the DIP cannot obtain financing by offering any of the above, he may obtain financing after notice and hearing by offering a senior security interest on encumbered property, but only if he is unable to obtain financing otherwise and there is adequate protection of the interest of the lien holder.

i. Equity Financing. Some courts allow equity to provide new value when financing cannot be obtained elsewhere, but this brings up issues of absolute priority, discussed below.

ii. Cross-Collateralization. Cross-collateralization in return for post-petition financing is not authorized by the Code and is beyond the scope of the bankruptcy court's power to grant. *Shapiro v. Saybrook Manufacturing*.

iii. Appeal of an Order Granting Post-Petition Financing. §364(e) does not allow an order authorizing the obtaining of financing to be disturbed upon reversal or modification on appeal unless the lower court granted a stay of the order and the appealing party posts a substantial bond.

D. **Adversary Proceedings.** An adversary proceeding is a lawsuit that is brought within

a bankruptcy proceeding, governed by special procedural rules, and based on conflicting claims usually between the debtor and a creditor or other interested party. They are often brought to avoid liens or other transfers.

- E. **Conversion or Dismissal: §1112.** The debtor is allowed to convert a case to Chapter 7. The court can convert or dismiss the case for cause (see §1112(b)(4)), unless an opponent to conversion establishes that there is a reasonable likelihood that a plan will be confirmed within the applicable timelines or within a reasonable period, and the grounds for converting or dismissing the case include an act or omission of the debtor for which there exists a reasonable justification and that will be cured within a reasonable period of time. Courts have consistently dismissed Chapter 11 petitions filed by financially healthy companies with no need to reorganize under the protection of Chapter 11. *In re SGL Carbon Corp.* However, the Bankruptcy Code encourages filing early, sometimes even when the business is solvent. *Id.* The absence of a valid reorganization purpose and the consequent lack of good faith must be demonstrated. *Id.*

V. **COMMON PLAN STRUCTURES.** Which of the following reorganization structures is chosen is usually driven by tax consequences consideration.

- A. **Earn-Out.** An earn-out is a plan whereby the debtor repays debt over a period of time with profits from the company.
- B. **Pot Plan.** A pot plan is usually some variant of the following. The debtor binds itself for a period of time to give all income created to a pot. The contents of the pot are then distributed to creditors based on priority. Thus, all creditors will receive a certain percentage of their claims by way of the pot.
- C. **Hybrid Payout Plan with Sales.** The debtor agrees to slim down by selling unprofitable divisions while keeping profitable ones, and then further agrees to pay either in an earn-out or pot plan.
- D. **Swap of Debt for Equity.** Often, the debtor owes more than the business is worth and equity is not prepared to contribute new value. In such a case, a debtor can cancel all existing shares of stock, and then propose to pay creditors by issuing stock in the reorganized entity pro rata. The creditors receiving stock become the owners of the business with the power to run the business.

*Variation: Dirt for Debt* – Here, the debtor gives various creditors, or groups of creditors, liens on individual properties, which can then turn around and sell the properties at their discretion.

- E. **Sale as Going Concern.** The debtor can be sold as a going concern to a new investor, with the proceeds to be distributed to creditors. Such a transaction might occur by a sale of assets, or it might occur by a sale of stock (some involve both, as when a new corporation is formed to which all of the debtor's assets are transferred

and the stock of the new corporation is then issued to the purchaser).

**G. Sale of Tangible Assets as a Package or Piecemeal.** Here, many assets are sold as a package but without the sale of the company as a whole (*i.e.*, without the personnel and intangibles that make the company a going concern). Also, the assets can be sold piecemeal, which is the sale of part of the debtor's business or assets, either the sale of a profitable division to generate necessary cash or the sale of a loser that the purchaser thinks can be turned around by new management.

**H. Leveraged Buyouts.** Here, the company or a division is sold, with the purchase price provided largely by bank loans or commercial paper secured by the assets being purchased. The purchasers in such transactions are often the management and employees of the business or division being sold. LBOs of businesses in bankruptcy are often accompanied by employee agreements to work for less or to terminate bitter strikes in order to save jobs and give the company a reasonable shot at successful reorganization.

**VI. CONFIRMING THE PLAN.** A plan of reorganization will offer to pay each "class" of creditors a certain percentage of their claims over a stated period of time, with payment to be made in cash, in property, or in securities issued by the reorganized debtor. The plan and an explanatory disclosure statement are distributed to all creditors who have filed claims. The plan is then put to a vote. If the vote is approved by the specified majorities of creditors in each class, §1126(c), it will be confirmed by the court, provided that it also conforms to the requirements of §1129. Upon confirmation of the plan, the debtor is discharged from all its pre-petition debts except as provided in the plan. §1141(d).

*Exclusivity:* §1121 – §1121(b) gives the debtor 120 days in which to propose its own plan of reorganization and §1121(c)(1) gives 180 days to solicit votes and confirm the plan. Both times are measured from the date of filing and overlap each other. During these times, no other party in interest can propose or solicit a different plan of reorganization. Prior to the 2005 Amendments, the courts had the power to extend exclusivity indefinitely. After the 2005 Amendments, §1121(d)(2) imposes a cap on judicial discretion of 18 months to propose a plan and 20 months (again overlapping dates) to solicit votes. Exclusivity is terminated by the appointment of a trustee. §1121(c)(a). It can also be shortened or increased for cause. §1121(d)(1). In a small business case, the debtor gets 180 days to file a plan with exclusivity, and 300 days to file a plan in general without exclusivity.

*Requirements* – A plan must: (1) designate classes of claims (both claims to money and claims of ownership interest); (2) which classes are or are not impaired; (3) specify the treatment of each class; (4) provide same treatment intra-class (absent agreement otherwise); (5) provide adequate means for implementation of plan by retention, sale, merger, transfer of property of estate, etc.; (6) satisfaction of liens, cancellation of instruments, extension of maturities, change in interest rates, amend charter, issue new securities, etc. In addition, the plan must contain provisions that are consistent with the interest of creditors and equity and with public policy with respect to selection of officers and directors.

- A. **Present Value.** Secured creditors are entitled to the present value of their allowed secured claims. Unsecured creditors are entitled to the present value of what they would have received in a Chapter 7. §1129(a)(7).
- B. **Best Interests of Creditors.** The plan must be in the “best interests” of each individual creditor who does not agree to the plan. §1129(a)(7). This standard applies to each creditor, not each class, and any individual creditor may raise this issue with the court. Thus, a finding must be made that each creditor who does not individually vote in favor of the plan would have received at least as much in a Chapter 7. In so determining, the court will do a liquidation analysis, and the burden is on the proponent of the plan to show the liquidation value of the company in order to determine how much the creditor would receive in a Chapter 7.
- C. **Feasibility.** The plan must be found feasible even if every creditor agrees to it. Feasibility goes to the likelihood that the plan will succeed; that the business will survive and prosper at least long enough to make the scheduled payments. Although success does not have to be guaranteed, the court is obligated to scrutinize a plan carefully to determine whether it offers a reasonable prospect of success and is workable. *In re Malkus, Inc., Debtor.* Visionary schemes are not sufficient to make a plan feasible. *Id.* A debtor’s past performance is one of the most important measures of whether a debtor’s plan will succeed. *Id.* Sincerity, honesty and willingness are not sufficient to make the plan feasible. *Id.* The test is whether the things which are to be done after confirmation can be done as a practical matter under the facts. *In re Made in Detroit, Inc., Debtor.*
- D. **Impairment.** “Impairment” refers to whether a creditor class will be completely protected under the plan. *Bernhard Steiner.* By operation of law, an unimpaired class is “deemed to have accepted the plan. §1126(f). In addition, an unimpaired class satisfies the best interest test by definition. §1124(1) provides that a claim is impaired unless the plan “leaves unaltered the legal, equitable, and contractual rights to which such claim ... entitles the holder of such claim.” *In re PPI Enterprises (U.S.), Inc.* A plan does not impair a class solely because it leaves a claimant subject to applicable provisions of the Code; impairment by the Code or other statute does not alter a claimant’s legal rights, and thus is not impairment. *Id.*

*Solicitation and Disclosure* – The disclosure statement is the central document in a Chapter 11 because it is the basis on which the creditors vote. A disclosure statement must have “adequate information” in order to be approved for use in solicitation of acceptances or rejections of the plan. §1125(a). In determining whether a disclosure statement has adequate information, courts look at the complexity of the case and the cost or benefit of requiring additional information. A disclosure statement should find a balance between adequate information and simplicity so that the average creditor can read and understand what he is voting for or against.

- A. **Required Disclosures.** All creditors in a single class must receive the same disclosure, but it is possible for different disclosure statements to be given to different

classes. A disclosure statement must contain the following information (as described by the court in *In re Malek*).

- i. Description of the Business. This analysis must include the competitive conditions in the industry and the debtor's role in that industry. The debtor should provide a description of the service to be rendered, location of principal and branch offices, employee staff and payroll, salaries of officers, and directors.
- ii. A History of the debtor Prior to Filing. This history should be provided in a neutral, objective and noninflammatory manner.
- iii. Financial Information.
- iv. Description of the Plan. The plan must be described in sufficient detail to give the creditors enough information to determine how their rights will be affected.
- v. How the Plan is to be Executed.
- vi. Liquidation Analysis.
- vii. Management to be Retained and the Compensation of the Personnel Retained.
- viii. Projection of Operations.
- ix. Litigation
- x. Transactions with Insiders.
- xi. Tax Consequences.

**B. Disclosure in Small Business Cases.** In small business cases (defined in §101(51D)), the disclosure statement need not be a separate document if the court determines that the plan itself provides adequate information.

**C. Solicitation: §1125(b).** The acceptance or rejection of a plan may not be solicited after the commencement of a case from a holder of a claim with respect to such interest, unless before such solicitation there is a plan or summary of the plan and an approved written disclosure statement given to such claim holder. Votes obtained without approved disclosure are subject to being stricken.

*Classification and Voting* – Creditors are divided into classes for purposes of voting and distribution, with those in a class sharing similar legal status and pro rata distribution.

**A. Voting.** A class of claims has accepted a plan if such plan has been accepted by creditors that hold at least two-thirds in amount and more than one-half in number of allowed claims of such class held by creditors that have voted. §1126(c). Votes of acceptance are to be computed only on the basis of filed and allowed proofs of claim. *In re Figter*. Each creditor is entitled to one vote for each of its claims in each class. *Id.* If the class is unimpaired, then the class is deemed to have accepted the plan, and if the class receives nothing they are deemed to have rejected the plan. §1129(f) and (g).

**B. Classification.** §1122(a) specifies that only claims which are “substantially similar” may be placed in the same class. *In re U.S. Truck Co., Inc.* It does not require that similar claims must be grouped together, but merely that any group created must be homogenous. *Id.* However, there is some limit on a debtor's power to classify creditors. *Id.* Whether a classification is proper is determined by the factual

circumstances of each individual case. *Id.*

- i. “Rational Business Justification” and Separate Classification. Separate classification is permitted for “good business reasons.” *In re Bernhard Steiner Pianos USA, Inc.* Where a continuing relationship with an unsecured creditor who had a distinct interest in the debtor’s business was essential to the continued operations of the debtor, separate classification of that creditor was for a good business reason. *Id.* This issue is important in a cramdown plan (below). Debtors often attempt to separately classify certain claims in order to obtain a consenting class for purposes of cramdown.

*In re Barrakat* – The court in this case did not allow separate classification because the debtor offered no business or economic justification for separate classification. The court determined that the sole purpose of the separate classification was to obtain acceptance of the plan under cramdown provisions. Specifically, the court disallowed separately classifying a deficiency claim from other general unsecureds, and disallowed separately classifying certain trade creditors because they were not essential to debtor’s continued maintenance. The court did allow, however, separate classification of tenants’ pre-petition security deposits since the claims were legally different from other unsecured claim under California law. In a SARE, the debtor cannot separately classify the deficiency class from the general unsecureds unless there is a reasonable business justification that does not involve gerrymandering.

*Cramdown: §1129(b)* – If a class rejects the plan, the plan cannot be confirmed as a consensual plan under §1129(a). However, the court will confirm the plan anyway if it does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan. §1129(b)(1). Confirmation under subsection (b) is commonly referred to as “cramdown” because it permits a reorganization plan to go into effect over the objections of one or more impaired classes of creditors. *In re U.S. Truck Co., Inc.* To qualify for cramdown, the plan must attract at least one consenting class of impaired creditors, otherwise it cannot be confirmed. §1129(a)(10).

- A. **Fair and Equitable.** A cramdown plan must be fair and equitable, as discussed in §1129(b)(2). These minimum requirements are divided into three categories – (b)(2)(A), (B), and (C) – governing the rights of secured creditors, unsecured creditors, and equity holders, respectively.

*Secured Creditors: §1129(b)(2)(A)* – The rule says that, as it concerns a class of non-consenting class of secured creditors, the plan must treat such creditors in the one of the following ways: (i) creditor retains lien and receives payments that total at least to the allowed secured claim *and* of a present value equal to the value of the interest in the property securing the claim, (ii) the plan provides for sale with liens attaching to proceeds and subject to the creditor’s right to credit bid under 363(k), or (iii) the plan provides for the “indubitable equivalent” of the secured claim.

- i. Present Value. Whether a secured creditor is receiving the “present value” equal to the value of its interest in the property securing the claim comes down to whether the plan’s interest rate is correct. How to determine the correct interest rate is subject to debate, but Judge Albert prefers to use the blended rate method.
- ii. §1111(b) Election. This election benefits secured creditors that are undersecured. By using §1111(b)(1)(B), the undersecured creditor can waive any deficiency or unsecured claim that would result from the creditor’s undersecurity and thus waive any participation in the plan as an unsecured creditor. In exchange, the debtor is forced to pay the secured creditor over time the full number of dollars that the creditor is owed. But the debtor is not required to pay the present value of the entire claim, only the present value of that portion of the claim equal to the value of the collateral. The creditor must make the decision by the time the disclosure statement is approved, unless the court extends the time. Rule 3014.

*Unsecured Creditors, Equity, and the Absolute Priority Rule* – If a class of unsecured creditors votes against the plan, then equity may not receive anything under the plan. §1129(b)(2)(B). Similarly, if a class of preferred stockholders votes against the plan, then junior/common stockholders may not receive anything under the plan. §1129(b)(2)(C). Thus, a class that votes against the plan must be paid in full, or else the plan must provide that any classes junior to the non-consenting class will get nothing.

- i. New Value Exception. Some courts recognize a judicial exception to the rule that says that when equity provides new value that can’t be obtained elsewhere to finance the reorganization, the court may permit equity to retain ownership if it is convinced that the bargain is fair and that creditors will be benefited. *Case v. Los Angeles Lumber Products Co.* explained that where the necessity for new capital exists and the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made. *203 North LaSalle Street Partnership* explained that, assuming a new value exception exists, plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation fail. Thus, exposure to the market is essential to obtain that new value, and a plan that provides an exclusive right to the existing shareholders to bid for shares in the reorganized debtor is not confirmable. *In re MJ Metal Products, Inc.*

**VII. POST CONFIRMATION AND DISCHARGE.** §1141 discharges almost all debts up to the moment of confirmation. There are three issues that arise. The first is that there is a serious and continuing split among the circuits about when claims arise for the purposes of discharge (discussed above). The second are issues of notice. The notice required is notice of the chapter 11 case and its plan of reorganization. Disputes about notice are a second

occasion to determine whether certain creditors' claims against the debtor have or have not been discharged. The third post-petition set of problems is occasioned by the claim by a third party, often an insider of the debtor, that the plan has discharged the liabilities of the third party as well as those of the debtor.

*Discharge* – At the moment of an individual's discharge, the Section 362 automatic stay is replaced with the Section 524 discharge injunction. The discharge voids any judgment against the debtor and operates as an injunction stopping creditors from attempting to collect either from the debtor or from the debtor's property.

**A. Effects of Confirmation: Claims against the Debtor.** Once, confirmed, the plan binds the debtor and all creditors, whether or not a creditor has accepted a plan. Whether a claim against the debtor survives confirmation and discharge turns on timing and notice. The first point, timing, depends on the time period to which a claim is assigned, pre-confirmation or post-confirmation. Sometimes claims that arise post-confirmation have roots in the pre-confirmation past, creating the issue of future claims that is discussed above.

- i. Notice. Discharge under the Code presumes that all creditors bound by the plan have been given notice sufficient to satisfy due process. *U.S.H.* Due process is met if notice is reasonably calculated to reach all interested parties, reasonably conveys all of the required information, and permits a reasonable amount of time for response. *Id.*, quoting *Mullane v. Central Hanover Bank*. In *Mullane*, the Supreme Court held that an elementary and fundamental requirement of due process in any proceeding which is to be accorded finality is notice reasonably calculated, under all circumstances, to apprise interested parties of the pendency of the action and afford them an opportunity to present their objections. *Id.* Thus, if a creditor is not given reasonable notice of the bankruptcy proceeding and the relevant bar dates, its claim cannot be constitutionally discharged. *Id.*

*Reasonable Notice: Known v. Unknown Creditor* – When a creditor is unknown to the debtor, publication notice of the claims bar date may satisfy the requirements of due process. *Id.* However, if a creditor is known to the debtor, notice by publication is not constitutionally reasonable and actual notice of the relevant bar dates must be afforded to the creditor. *Id.* A “known” creditor is one whose identity is either known or reasonably ascertainable by the debtor. *Id.* An “unknown” creditor is one whose interests are either conjectural or future or, although they could be discovered upon investigation, do not in due course of business come to knowledge of the debtor. *Id.* Debtors cannot be required to provide actual notice to anyone who potentially could have been affected by their actions, such a requirement would completely vitiate the important goal of prompt and effectual administration and settlement of debtors' estates. *Id.*

**B. Effects of Confirmation: Debtor's Claims.** Debtor's claims are not discharged

under §1141, but other legal doctrines may bar the debtor from pursuing them.

- i. *Res Judicata*. A plan is binding upon all parties once it is confirmed and all questions that could have been raised pertaining to such plan are res judicata. *In re Howe*. The test for res judicata requires that: (1) the parties be identical in both suits, (2) a court of competent jurisdiction rendered the prior judgment, (3) there was a final judgment on the merits in the previous decision, and (4) the plaintiff raises the same cause of action or claim in both suits. *Id.* Thus, if the debtor should have brought up a claim while in bankruptcy and failed to do so, then the debtor will be barred from pursuing that claim after confirmation.

*Transactional Test* – The transactional test is a test for determining whether two suits involve the same claim for res judicata purposes. *Id.* Under this approach, the critical issue is not the relief requested or the theory asserted but whether plaintiff bases the two actions on the same nucleus of operative facts. The rule is that res judicata bars all claims that were or could have been advanced in support of the cause of action on the occasion of its former adjudication, not merely those that were adjudicated. *Id.*

- C. **Effects of Confirmation: Discharge of Non-Debtors.** In an interrelated group, persons and entities other than the debtor may contribute money or talent that is essential to a reorganization. Often, they will want to be released from future liability in return for their contributions. In the Ninth and Tenth Circuits, a bankruptcy discharge does not release a non-debtor of liability, except in asbestos cases. *In re Metromedia Firber Network*. In other circuits, non-debtor discharge is only granted in rare situations. *Id.* In one case, non-debtor discharge was allowed because the estate received substantial consideration, the enjoined claims were channeled to a settlement fund rather than extinguished, the enjoined claims would indirectly impact the debtor's reorganization by way of indemnity or contribution, and the plan otherwise provided for full payment of the enjoined claims. *Id.*

*Injunctions* – Generally, a plan of reorganization cannot be confirmed if the Plan purports to release guarantors of the debtor's debts and a creditor objects to the release. *In re Bernhard Steiner Pinaos*. In bankruptcy cases, a court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan. *SEC v. Drexel Burnham Lambert Group*. The Fifth Circuit has held that post-confirmation permanent injunctions that effectively release a non-debtor from liability are prohibited. *Feld v. Zale Corp.* However, temporary injunctions may be proper under unusual circumstances. *Steiner*.

- i. *Elements*. Temporary injunctions may be granted (1) when the non-debtor and debtor enjoy such an identity of interest that the suit against the non-debtor is essentially a suit against the debtor, and (2) when the third-party action will have an adverse impact on the debtor's ability to accomplish reorganization. *Steiner*. In order to obtain injunctive relief generally, the moving party must show: (1) a substantial likelihood that the movant will

prevail on the merits; (2) a substantial threat that the movant will suffer irreparable injury if the injunction is not granted; (3) that the threatened injury to the movant outweighs the threatened harm an injunction may cause to the party opposing the injunction; and (4) that the granting of the injunction will not disserve the public interest.