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1 Collier Business Workout Guide Acknowledgments

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Acknowledgments

We would like to thank the many attorneys at Debevoise & Plimpton LLP who contributed their time and effort to this book. The legal issues raised in the context of a troubled company restructuring require the skill and knowledge of lawyers experienced in bankruptcy, corporate finance, mergers and acquisitions, litigation and tax law. Listed below are the names of those lawyers who were the main contributors to the 2007 revisions to this book.

Daniel Backenroth, Lindsay K. Blanco, Maureen A. Cronin, Bryan R. Kaplan, Vadim Mahmoudov, Rachel Jaffe Mauceri, Jasmine Powers, Kelly J. Rezny, Hilary Sokolowski, Ilissa L. Watnik and Harry Zirlin.

Deborah F. Stiles was an original co-author.

We would also like to thank the editors-in-chief, Professor Alan N. Resnick and Henry J. Sommer, and everyone at Matthew Bender who assisted in the preparation of this book.

This book is dedicated to our spouses, Georgie, Rebecca, Gerrie and Martin.



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1 Collier Business Workout Guide Foreword

Foreword

Foreword

If a company is confronted with a financial crisis, should management file for protection pursuant to chapter 11 of the United States Bankruptcy Code or should it try restructuring in an out-of-court workout? Does a director have to shift his or her focus from shareholders to creditors once the company that he or she serves falls upon hard times? What steps may a lender take to protect its loan without subjecting it to litigation for exercising undue control? What peculiar pitfalls await an investor who tries to take control of a company that is on the brink of disaster? How is an exchange offer different from a prepackaged bankruptcy and under what circumstances can the prepackaged bankruptcy avoid the problems of a "free fall" chapter 11 case?

This book deals with the legal issues presented when a company in financial distress seeks to restructure without undertaking the long, expensive and grueling process of reorganizing under chapter 11. Whereas most publications focus on one facet of the troubled company--what precautionary steps should a lender take or how management might seek to reorganize--the premise of this book is that the successful conclusion of a workout requires an understanding of how the troubled company's many different constituencies react in crisis. It is only through an understanding of the whole workout process that an attorney, whether representing the debtor, a creditor or another interested party, can hope to guide the client through the difficulties of a restructuring.

When a company slips into financial crisis, most interested parties are confronted with pivotal decisions that have a significant impact on both themselves and the corporate entity. Members of senior management are forced to make crucial business decisions affecting the company's very existence and their own livelihoods. Directors who might have thought that service on the board would entail little more than attendance at board meetings a few times a year are suddenly confronted by critical decisions that might result in their own liability and might mark the difference between the survival and ruin of the enterprise. Lenders, suppliers and customers must rethink their relationships with the troubled company.

An out-of-court restructuring is a process by which these participants, first separately and then together, make decisions that either restore the company to health or send it to oblivion. To successfully guide a debtor, creditor, board member or investor through the legal and financial issues that one confronts in a workout, it is critical that counsel view the process as a whole, considering how each competing group views its position and makes its decisions. To accomplish this, counsel must necessarily bring a broad range of legal expertise to the representation.

1 Collier Business Workout Guide Foreword

Since the business restructuring is always viewed as an alternative to a chapter 11 case, with every decision weighed against what the outcome would be in a bankruptcy case, Chapter 1 of the book presents an overview of the Bankruptcy Code.

Chapter 2 deals with the basic decision-making process of the troubled company's management. Should it restructure outside of bankruptcy or does it need the protection afforded by a chapter 11 case? How does management determine the benefits and risks inherent in various restructuring alternatives?

In Chapter 3 this analysis continues, but from the perspective of the company's board of directors. They are forced to confront the fact that they may owe fiduciary duties to creditor constituencies as well as to the company's shareholders. How does the board decide which restructuring course is appropriate?

The focus of the book then shifts to problems that an attorney confronts representing a lender to the troubled company. Chapter 4, in addition to describing the due diligence investigation a lender must undertake before advising the client on its restructuring goals, analyzes the various legal theories that fall under the rubric of "lender liability." The central part of the chapter describes the various fraudulent conveyance cases that arose out of the leveraged buyouts of the 1980s and their impact on lenders.

Chapters 5 and 6 bring another group into the discussion--public bondholders. The formation of bondholder committees and the negotiating tactics employed by the company and these committees are discussed. The major part of these chapters is devoted to the various types of exchange offers and prepackaged bankruptcy plans utilized by companies to solicit acceptances of restructuring proposals from holders of public debt. Prepackaged plans, with their variations, are one of the favorite ways to restructure large troubled companies.

Chapter 7 looks at the troubled company from a very different perspective. While the company's management, directors and lenders see only the pain involved in dealing with a company in crisis, the investor sees an opportunity for gain and potential control. Chapter 7 provides the investor with a guide through the mine field of legal issues that arise when purchasing claims against or assets of, or seeking control of, a troubled company.

Chapter 8 presents the tax issues that confront the troubled company, since many restructurings must be structured to avoid adverse tax outcomes. In certain instances, in fact, a company's net operating losses may represent its largest asset and their preservation becomes a matter of great concern to all participants in the workout.

Finally, Chapter 9 brings the discussion back to the company and presents a practical guide to preparing for a chapter 11 case in the event that an out-of-court restructuring fails.

In a one volume work, it is impossible to give complete coverage to any of the bodies of law dealt with in these chapters. Instead, we have focused on the major legal issues that confront various parties in a restructuring and have outlined the legal framework within which these decisions are made.



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1 Collier Business Workout Guide About the Collier Editors-in-Chief

About the Collier Editors-in-Chief

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Professor Resnick was appointed by Chief Justice William H. Rehnquist to serve as Reporter to the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States, a position he held from 1987 to 1999. He has been a member of the Advisory Committee since 1999. Professor Resnick also testified before congressional and National Bankruptcy Review Commission committees on various issues relating to bankruptcy legislation.

Professor Resnick's writings have been cited in more than 150 judicial opinions, including opinions of the U.S. Supreme Court. He is co-author of Weintraub & Resnick, *Bankruptcy Law Manual* (West) and is co-editor of *Bankruptcy Reform Act of 1978: A Legislative History* (Wm. Hein). He has written numerous articles on bankruptcy and commercial law, including articles that have appeared in the *American Bankruptcy Law Journal*, *Banking Law Journal*, *Uniform Commercial Code Law Journal*, *University of Pennsylvania Law Review*, *Rutgers Law Review* and *William & Mary Law Review*. He also is a frequent speaker at professional seminars and educational programs. He has lectured at Federal Judicial Center seminars for bankruptcy judges, at the National Conference of Bankruptcy Judges and at various bar association programs. Professor Resnick has been on the faculty of the annual New York University Workshop on Bankruptcy and the faculty of the Uniform Commercial Code Institute in Washington, D.C.

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Mr. Sommer is the author of *Collier Consumer Bankruptcy Practice Guide* (Matthew Bender), *Consumer Bankruptcy Law and Practice* (Nat'l Consumer Law Center), *Consumer Bankruptcy* (Wiley) and numerous articles on bankruptcy law. He is co-author of *Collier Family Law and the Bankruptcy Code* (Matthew Bender), Editor of *Collier Bankruptcy Manual* (Matthew Bender 3d ed. rev.) and a contributing author to *Debtor-Creditor Law* (Matthew Bender).

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What's New

1 Collier Business Workout Guide Scope

Scope

HIGHLIGHTS

Release 16 December 2009

2009 Release.

Chapters 3, 4, 5, 6, and 9 of the *Collier Business Workout Guide* have been revised and updated to include the latest statutory and case law, ensuring this publication remains an essential resource for planning, executing, and completing an effective out-of-court restructuring, or "Workout."

New subsection P 5.13[3] has been added to chapter 5 regarding "Coercive" Exchanges.

Deepening Insolvency. (*Chapter 4*). The court held in *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.* that an independent cause of action for deepening insolvency does not exist under Delaware law. Instead, the court noted that actions may be brought for a breach of fiduciary duty or fraud.

"Coercive" Exchanges. (*Chapter 5*). New subsection P 5.13[3] discusses the various strategies that troubled companies may attempt to employ that may leave nonparticipating bondholders in a worse position, and that these bondholders who believe their interests are being harmed by these tactics may challenge these "coercive" exchanges in court.

Third Party Releases. (*Chapter 6*). P 6.05 lists the factors that allows the bankruptcy court to enjoin a creditor's claim against a non-debtor third party under "unusual circumstances."

Cross-Collateralization and Roll-Ups. (*Chapter 9*). P 9.08 discusses prepetition lenders providing postpetition financing may require that some or all of the prepetition financing be "rolled-up" into the postpetition financing. This will result in the entire prepetition facility becoming a postpetition secured facility with super-priority administrative expense status.



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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.01 Scope and Use of This Chapter.

It may seem somewhat unusual that a book that focuses primarily on out-of-court business restructurings begins with a discussion of chapter 11 of the United States Bankruptcy Code (the "Bankruptcy Code").ⁿ¹ However, it makes good sense when one considers that consensual business restructurings inevitably are negotiated in the shadow of chapter 11. For example, the most fundamental question a practitioner in this area faces--namely whether a troubled company should file for chapter 11 protection or seek an out-of-court restructuring--cannot be answered without at least some understanding of how the Bankruptcy Code works.ⁿ² Consequently, it is crucial for a lawyer advising a troubled company to be familiar with the basic framework of chapter 11 and its salient provisions.

This chapter, while far from an exhaustive treatment of the subject, seeks to provide this framework by identifying certain themes that underlie the Bankruptcy Code--such as "rehabilitation of the debtor" and "equality of treatment of creditors"--and examining how these themes are manifested in certain key Bankruptcy Code provisions.ⁿ³ Specifically, this chapter discusses the roles of the various parties in a chapter 11 case (the debtor in possession, the official committees, the court and the Office of the United States trustee, a component of the Department of Justice responsible for overseeing the administration of bankruptcy cases (the "United States trustee")), the way in which the automatic stay works, the operation of the debtor's business within a chapter 11 case (including the use, sale and lease of the debtor's property, postpetition financing and the assumption or rejection by the debtor of its executory contracts and unexpired leases), the powers to recover property for the debtor's estate, including the rules of preferences and fraudulent conveyances, and the process of plan formulation and confirmation.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. The Bankruptcy Code is codified at *11 U.S.C. §§ 101, et seq.* Since the Bankruptcy Code became effective on October 1, 1979, it has been amended on several occasions. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994 and *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised), made substantial changes to the Bankruptcy Code and the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (enacted on April 20, 2005) (sometimes referred to as the 2005 Act). With certain exceptions, the amendments made by the 2005 Act apply to cases filed on or after October 17, 2005. *See* Pub. L. No. 109-8, § 1501 (setting forth the effective date of the 2005 Act).

(n2)Footnote 2. *See* ch. 2, *infra*, for a discussion of how a troubled company decides whether to file for bankruptcy protection or to pursue an out-of-court restructuring. In addition, *see* ch. 6, *infra*, for an analysis of prepackaged

bankruptcy plans and ch. 9, *infra* , for a discussion of preparing a company to file for chapter 11 protection.

(n3)Footnote 3. For more comprehensive guides to the Code, see Collier on Bankruptcy (Matthew Bender 15th Ed. Revised) and Collier Bankruptcy Practice Guide (Matthew Bender).

(n4)Footnote 4. The 2005 Act changed certain Bankruptcy Code provisions applicable to small business debtors. As amended, the Bankruptcy Code provides for oversight of small business cases by the United States trustee, new financial reporting requirements, shorter mandatory confirmation guidelines, and the unavailability of an automatic stay in limited circumstances. See 28 U.S.C. § 508; 11 U.S.C. §§ 308, 1129(e), 362(n). The 2005 Act also changed the definition of "small business" debtor. See 11 U.S.C. § 101(51D). "Small business debtor" is now defined as a person engaged in commercial or business activities (including an affiliate of such person that is also a debtor, but excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) having aggregate noncontingent, liquidated secured and unsecured debts of not more than \$2 million (excluding debts owed to affiliates or insiders of the debtor) as of the date of the petition or the order for relief. This monetary definition applies only in a case where the United States trustee has not appointed a creditors' committee or where the court has determined that the creditors' committee is not sufficiently active and representative to provide effective oversight of the debtor. It does not apply to any member of a group of affiliated debtors that has aggregate noncontingent, liquidated secured and unsecured debts in excess of \$2 million (excluding debts owed to one or more affiliates or insiders). See Report of the Committee on the Judiciary, H.R. Rep. No. 109-31, pt. 1, to accompany S. 256, 109th Cong., 1st Sess., § 432 (2005). Under the Bankruptcy Code, "person" includes individuals, partnerships, and corporations. See 11 U.S.C. § 101(41). The provisions of the Bankruptcy Code relating to small business debtors are discussed herein where appropriate.

It should be noted that this chapter does not discuss the Bankruptcy Code's liquidation provisions in any detail since these provisions are generally not relevant to consensual business restructurings.



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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.02 Objectives of the Bankruptcy Code.

Although one can argue whether the Bankruptcy Code has a pro-debtor or pro-creditor orientation, there are clearly two policy goals embedded in the Bankruptcy Code: (1) rehabilitation of the financially troubled company and (2) equality of distribution among its similarly situated creditors.

[1] Preservation and Rehabilitation of the Debtor.

When a company experiences financial difficulties, the preference of the Bankruptcy Code is that the company be preserved and revitalized. The rationale for this fresh start approach is that generally a business has greater value as a going concern than if dismembered and liquidated and that therefore maximum value can be realized for all interested parties--creditors, equity holders and employees--through continuity of operation and management. These concepts of "reorganization" are embodied in chapter 11 of the Bankruptcy Code, the provisions of which are intended to give the troubled company the necessary time and protections with which to restructure its debt and reorganize its affairs.ⁿ¹ If reorganization cannot be accomplished, chapter 7 of the Bankruptcy Code provides the statutory framework for the debtor's orderly liquidation.

[2] Equality of Distribution.

The second policy objective of the Bankruptcy Code is to ensure that creditors and interest holders of equal rank share equally in the distribution of the value of the debtor's reorganized operation. This objective is embodied in the Bankruptcy Code's automatic stay provisions, its various protections from creditors, its avoidance actions, its ranking of claims and interests and its requirements for a plan of reorganization. This policy seeks to forestall creditors' racing to protect and enhance their own interests at the expense of other creditors or interest holders.

FOOTNOTES:

(n1)Footnote 1. H.R. Rep. No. 595, 95th Cong., 1st Sess. 220 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 989, 95th Cong., 2d Sess. 10 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).



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Collier Business Workout Guide

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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.03 Filing Options.

[1] Eligibility for Relief.

A case under the Bankruptcy Code is initiated by the filing of a petition for relief.ⁿ¹ The eligibility requirements for chapter 11 relief are set forth in *sections 109 and 303(a) of the Bankruptcy Code*. In general, a chapter 11 debtor must reside or have a domicile, place of business or property in the United States. Certain business entities, such as stockbrokers, insurance companies, banks and savings and loan associations are ineligible for chapter 11 relief.ⁿ²

[2] Voluntary and Involuntary Petitions.

A petition for relief can be either voluntary or involuntary. A voluntary petition is one filed by the debtor pursuant to section 301.ⁿ³ There is no requirement that the debtor be insolvent or unable to pay its debts as they mature. An involuntary petition is one filed pursuant to section 303 by three or more creditors each of which holds a claim that is neither contingent nor subject to a *bona fide* dispute as to liability or amount. The noncontingent, undisputed claims of the petitioning creditors must aggregate at least \$12,300 more than any lien on the property of the debtor securing such claims.ⁿ⁴

[3] Chapter 7 Liquidations.

If the purpose of seeking the Bankruptcy Code's protection is not rehabilitation, but rather to provide for an orderly liquidation of the assets of the debtor, a petition may be filed under chapter 7.ⁿ⁵ In a chapter 7 liquidation, all property of the debtor, except exempt property, becomes property of the estate, which is then liquidated by a trustee. Generally, the trustee abandons any property in which the debtor has no equity and sells the remaining property. If the property is subject to a lien, the proceeds are first applied to the claims of secured creditors, and the balance of the proceeds, if any, becomes property of the estate. All of the property of the estate is converted into cash, which is first used to pay administrative expenses and the remainder distributed to creditors whose prepetition claims have been filed and allowed.ⁿ⁶

FOOTNOTES:

(n1)Footnote 1. See ch. 9 *infra*, for a discussion of preparing a company for a bankruptcy filing.

(n2)Footnote 2. See 11 U.S.C. § 109(b)&(d).

Stockbrokers and commodity brokers are eligible for relief only under chapter 7 of the Code. Stockbroker liquidations are covered in *sections 741 through 753 of the Code*, and commodity broker liquidations in sections 761 through 767. Stockbroker liquidations are also covered by the Security Investor Protection Act of 1970, as amended ("SIPA"). 15 U.S.C. §§ 78aaa-lll.

Although banks and insurance companies are not eligible for relief under either chapter 7 or chapter 11, a bank holding company and an insurance holding company may seek relief under chapter 11.

Clearing banks are eligible for relief under either chapter 7 or chapter 11 of the Code pursuant to amendments made by the Consolidated Appropriations Act, 2001, Pub. L. No. 106-554 (enacted on December 21, 2000), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41q(iii) (Matthew Bender 15th Ed. Revised). Clearing bank liquidations are covered in *sections 781 through 784 of the Code*.

(n3)Footnote 3. 11 U.S.C. § 301.

(n4)Footnote 4. 11 U.S.C. § 303(b)(1), as amended by Pub. L. No. 109-8 (2005). *Section 104 of the Bankruptcy Code* provides for the adjustment of dollar amounts in certain sections of the Bankruptcy Code every three years, beginning April 1, 1998. Most recently, section 303(b) was amended to reflect that only noncontingent, undisputed claims are considered in aggregating dollar amounts. For cases filed before April 1, 2004, the claim amount is \$11,625; for cases filed after April 1, 2004, the claim amount is \$12,300.

Under certain circumstances, a foreign representative (in a foreign proceeding) may also commence an involuntary case under section 303, or a voluntary case under section 301 or 302. *See 11 U.S.C. § 1511*. The 2005 Act repealed *section 304 of the Bankruptcy Code*, which provided a limited framework for international insolvency proceedings, and created a new chapter 15 that substantially incorporates the Model Law on Cross-Border Insolvency promulgated and adopted by the United Nations Commission on International Trade Law, or UNCITRAL, on May 30, 1997. The goal of the new chapter 15 is to encourage cooperation between the United States and foreign courts with respect to cross-border cases. *See Report of the Committee on the Judiciary*, H.R. Rep. No. 109-31, pt. 1, to accompany S. 256, 109th Cong., 1st Sess., title VIII (2005). Chapter 15 is designed as an avenue for bankruptcy courts to deal effectively with transnational insolvency cases, and it includes provisions that govern access of foreign representatives and creditors to the bankruptcy courts, recognition of foreign proceedings and relief, cooperation with foreign courts and foreign representatives, and concurrent proceedings.

(n5)Footnote 5. *See P 1.01 supra* for a discussion of the scope of this chapter.

(n6)Footnote 6. A chapter 11 case may result in a plan of reorganization that contemplates the liquidation of the debtor's assets. There are important differences between a liquidation pursuant to a chapter 11 plan of reorganization and a chapter 7 liquidation. For example, a chapter 11 sale may enable the business to be sold more readily as a going concern, thereby resulting in a greater return for the estate. In addition, a debtor that at least has the possibility of reorganizing itself is in a better bargaining position vis-a-vis possible purchasers than a company that is clearly liquidating. *See Lurey, Issues for Restructuring Public Debt Under Chapter 11*, Business Loan Workouts and Public Debt Restructuring, at 633 (PLI Com. L. & Practice Course Handbook Series No. 465, 1988).



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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.04 The Parties.

[1] The Court.

[a] Jurisdiction.

The United States district courts have original and exclusive jurisdiction over all cases under the Bankruptcy Code and over all of the property, wherever located, of the debtor and the estate.ⁿ¹ The district courts have original, but not exclusive, jurisdiction over civil proceedings arising under the Bankruptcy Code, or arising in or related to cases under the Bankruptcy Code.ⁿ² Bankruptcy judges are appointed within each district to serve as judicial officers of the district courtⁿ³ and constitute a division of the district court known as the bankruptcy court.ⁿ⁴ Congress intended that the district courts would refer cases and proceedings arising under the Bankruptcy Code to the bankruptcy courts, and the district courts have done so by local rules or general order.ⁿ⁵

[b] "Core" and "Non-Core" Matters.

Bankruptcy judges are empowered to hear and determine, subject to review by the district court, all cases under the Bankruptcy Code and all "core proceedings" arising under the Bankruptcy Code.ⁿ⁶ A core proceeding, generally speaking, is one that involves matters of estate administration, avoiding actions or some matters concerning property of the estate.ⁿ⁷

Final orders of the bankruptcy court in core proceedings are subject to review by the district court under the clearly erroneous standard of review. In contrast, the bankruptcy court in noncore proceedings may not enter final orders without the consent of the parties.ⁿ⁸ In such proceedings, the bankruptcy court submits proposed findings of fact and conclusions of law to the district court, which enters the final order after considering the proposed findings and conclusions and after reviewing *de novo* those matters to which any party has objected.ⁿ⁹

The bankruptcy court may conduct a jury trial if all parties expressly consent and the district court specifically designates that the bankruptcy court may exercise such jurisdiction. Absent these conditions, there is some controversy over whether the bankruptcy court may conduct a jury trial in either a core or noncore proceeding.ⁿ¹⁰

[c] Venue.

Venue in cases under the Bankruptcy Code is governed by 28 U.S.C. § 1408, which provides that venue lies in the district in which the domicile, residence, principal place of business or principal assets of the person or entity have been located for 180 days, or for a longer portion thereof than in any other district, prior to the filing of the petition.ⁿ¹¹ Venue is also proper in the district in which there is pending a case under the Bankruptcy Code of an affiliate, general partner or partnership of the person or entity.ⁿ¹²

The court may transfer a case to another district in the interest of justice or for the convenience of the parties.ⁿ¹³ The movant bears the burden of proof in a transfer of venue motion. It is not enough to show that one venue is inconvenient; the movant must show by a preponderance of the evidence that transfer is warranted.ⁿ¹⁴

[2] Debtor in Possession.

The Bankruptcy Code provides that, in a chapter 11 case, the existing management will continue to control and operate the debtor's business.ⁿ¹⁵ If necessary, a trustee may be appointed (1) for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management; (2) in the interest of creditors, equity security holders and other interests of the estate; or (3) if the grounds exist to convert or dismiss the case under *section 1112 of the Bankruptcy Code*.ⁿ¹⁶

Although the Bankruptcy Code is generally drafted in terms of the rights, powers and duties of the trustee as representative of the estate, the debtor is retained in possession in most chapter 11 casesⁿ¹⁷ and is the representative of the estate endowed with the rights, powers and duties of a trustee, except for the right to compensation and the power to investigate the affairs of the debtor.ⁿ¹⁸

A corollary to the presumption of continued control by current management is the presumed respect afforded the business judgment of the debtor. For example, although transactions not in the ordinary course of business require court approval,ⁿ¹⁹ a debtor can engage in transactions in the ordinary course of its business without prior court approval.ⁿ²⁰ While *section 1108 of the Bankruptcy Code* gives a bankruptcy court the power to circumscribe the authority of a debtor in possession in the conduct of its affairs, this power is rarely invoked.ⁿ²¹

[3] Official Committees.

[a] Official Committee of Unsecured Creditors.

The Bankruptcy Code provides for the participation of creditor constituencies in the reorganization of the debtor's business.ⁿ²² Pursuant to section 1102, the United States trustee appoints, at the commencement of the chapter 11 case, a committee of creditors holding unsecured claims.ⁿ²³ The committee is usually chosen from the list of the debtor's 20 largest unsecured creditors provided by the debtor pursuant to *Federal Rule of Bankruptcy Procedure 1007(d)*.ⁿ²⁴ The committee will ordinarily consist of the persons willing to serve holding the seven largest unsecured claims against the debtor, or will consist of creditors organized before the commencement of the case, if such committee was fairly chosen and is representative of the different kinds of claims to be represented.ⁿ²⁵ If a party in interest does not believe that a creditor's committee adequately or fairly represents the creditor constituency, that party can request that the court intervene.ⁿ²⁶

The committee of unsecured creditors is intended by the Bankruptcy Code to play a key role in the chapter 11 case. Because the debtor generally remains in control of its affairs and assets, the task of monitoring the debtor's activities and its compliance with applicable procedures falls to the creditors' committee and, to a lesser extent, to the United States trustee. The committee is specifically entitled to "party in interest" status and has the right to raise, appear and be heard on any issue in the case.ⁿ²⁷

The powers and duties of the committee are set forth in *section 1103 of the Bankruptcy Code* and consist of the

following in summary form:

- (1) consulting with the debtor in possession or trustee concerning case administration;
- (2) investigating the debtor's conduct, assets, liabilities and finances, the operation of the debtor's business and desirability of its continuation, and any other matter related to the case or the formulation of a plan of reorganization;
- (3) participating in the formulation of a plan of reorganization;
- (4) requesting the appointment of a trustee or examiner; and
- (5) performing other services in the interests of the creditors represented.

A committee appointed pursuant to *section 1102 of the Bankruptcy Code* is entitled to retain, at the expense of the estate, attorneys, accountants or other agents to represent or perform services for the committee.ⁿ²⁸

[b] Fiduciary Duties.

The members of an official committee owe a fiduciary duty to all creditors the committee represents.ⁿ²⁹ This duty is fulfilled by advising creditors of their rights and of the proper course of action in the case. The committee is required to provide access to information and solicit and receive comments from creditors that hold similar claims but who were not appointed to the committee.ⁿ³⁰ The court may compel the committee to provide any additional reports or information to non-committee members holding similar claims.ⁿ³¹ The members of a committee may not use their position to further their own interests at the expense of other creditors. Committee members are in a position of confidence and receive material, nonpublic information. Consequently, some companies insist that all committee members as well as their advisors sign confidentiality agreements concerning the information received during the restructuring process. In addition, a committee member may be prohibited from trading in the debtor's securities or, if its business is trading in securities, it may be required to establish a "Chinese wall" so that its trading strategy is not influenced by information obtained by virtue of membership on the committee.ⁿ³²

[4] Operating Trustee and Examiner.

Although the Bankruptcy Code presumes that the debtor will remain in control of its affairs, the bankruptcy court may, upon the motion of a party in interest or the United States trustee, appoint a trustee to manage the debtor's affairs.ⁿ³³ A trustee may be appointed for cause, including fraud, dishonesty, incompetence or gross mismanagement of the debtor's affairs by current management either before or after the commencement of the case.ⁿ³⁴ A trustee may also be appointed if it would be in the interest of creditors, equity security holders and other interests of the estate, or if grounds exist to convert or dismiss the case under *section 1112 of the Bankruptcy Code*.ⁿ³⁵ The number of security holders and the amount of assets or liabilities of the debtor are explicitly excluded from the consideration of whether to appoint a trustee.ⁿ³⁶

The "interests of creditors" is a flexible standard that permits the appointment of a trustee when no "cause" exists, by focusing on practical realities and the debtor's ability to progress towards a successful plan of reorganization.ⁿ³⁷ Among the factors for the court to consider are the trustworthiness of the debtor; the debtor's past and present performance and prospects for rehabilitation; the confidence or lack of confidence of the business community and creditors in present management; and the benefits derived by the appointment of a trustee balanced against the costs of appointment.ⁿ³⁸

The trustee becomes the central figure of the reorganization process, takes total control of the debtor's operation and

assumes the functions of the company's management.ⁿ³⁹

The Bankruptcy Code also permits, on motion of a party in interest or the United States trustee, the appointment of an examiner when there is no trustee.ⁿ⁴⁰ The examiner is charged with making the appropriate investigation of the debtor and its current or former management (including allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity) and reporting his or her findings. The court must order the appointment of an examiner upon the motion of a party in interest or the United States trustee if the debtor's fixed, liquidated unsecured debts exceed \$5,000,000ⁿ⁴¹ or if such appointment is in the interests of creditors, equity security holders or other interests of the estate.ⁿ⁴²

The appointment of an examiner does not displace current management. The debtor in possession continues to exercise its regular powers and to perform its regular duties.ⁿ⁴³

[5] United States Trustee.

The United States Trustee system was created to relieve bankruptcy judges of the burden of administrative matters in connection with debtors' estates. The powers and duties of the United States trustee are set forth at *28 U.S.C. § 586(a)*, including:

- (1) reviewing, in accordance with procedural guidelines adopted by the Executive Office of the United States Trustee, applications for compensation and reimbursement filed by professionals retained in connection with the case, commenting on such applications, and, if warranted, filing objections to such applications;
- (2) monitoring and commenting on plans and disclosure statements;
- (3) taking such action as the United States trustee deems appropriate to insure that all required reports, schedules and fees are properly and timely filed by the debtor;
- (4) monitoring the activities of statutory committees;
- (5) notifying the United States attorney of any matters that may constitute a crime and, if requested by the United States attorney, assisting in the prosecution of such crime;
- (6) monitoring and commenting on applications for retention of professionals pursuant to section 327;
- (7) monitoring the progress of cases and preventing undue delay; andⁿ⁴⁴
- (8) in small business cases, performing the additional duties specified in the Bankruptcy Code pertaining to such cases.

FOOTNOTES:

(n1)Footnote 1. *28 U.S.C. § 1334(a), (e)*. The "case" referred to in section 1334(a) is the case commenced by the filing of the petition for relief and includes all of the proceedings that follow the filing of the petition. The chapter 11 case ends only when it is closed under *section 350(a) of the Code*. See *11 U.S.C. § 350(a)*. Section 1334(e) was extended pursuant to the 2005 Act to explicitly confer upon the district courts jurisdiction "over all claims or causes of action that involve construction of Section 327" of the Bankruptcy Code, or rules relating to disclosure requirements thereunder. *28 U.S.C. § 1334(e)*. Section 327 governs retention of professionals in a bankruptcy case. See *11 U.S.C. § 327*.

(n2)Footnote 2. *28 U.S.C. § 1334(b)*. For a discussion of the bankruptcy court's jurisdiction over cases "arising in or related to" cases under the Bankruptcy Code, and how these terms have been defined in order to allow for

jurisdiction, *see* 1 *Collier on Bankruptcy*, P 3.01[1] *et seq.* (Matthew Bender 15th Ed. Revised).

(n3)Footnote 3. 28 U.S.C. § 152(a)(1).

(n4)Footnote 4. 28 U.S.C. § 151.

(n5)Footnote 5. The system of referral and powers of the bankruptcy judges are set forth at 28 U.S.C. § 157. This jurisdictional scheme was devised to meet the requirement of *Northern Pipeline Constr. Co. v. Marathon Pipe Line Co.*, 458 U.S. 50, 102 S. Ct. 2858, 73 L. Ed. 2d 598, 6 C.B.C.2d 785 (1982) , that judicial functions be supervised by a life-tenured Article III judge.

(n6)Footnote 6. 28 U.S.C. § 157(b)(1). A non-exhaustive list of "core proceedings" is set forth at 28 U.S.C. § 157(b)(2):

- (A) matters concerning the administration of the estate;
- (B) allowance or disallowance of claims against the estate or exemptions from property of the estate ...;
- (C) counterclaims by the estate against persons filing claims against the estate;
- (D) orders in respect to obtaining credit;
- (E) orders to turn over property of the estate;
- (F) proceedings to determine, avoid, or recover preferences;
- (G) motions to terminate, annul, or modify the automatic stay;
- (H) proceedings to determine, avoid, or recover fraudulent conveyances;
- (I) determinations as to the dischargeability of particular debts;
- (J) objections to discharges;
- (K) determinations of the validity, extent, or priority of liens;
- (L) confirmations of plans;
- (M) orders approving the use or lease of property, including the use of cash collateral;
- (N) orders approving the sale of property other than property resulting from claims brought by the estate against persons who have not filed claims against the estate;
- (O) other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or the equity security holder relationship, except personal injury tort or wrongful death claims; and
- (P) recognition of foreign proceedings and other matters under chapter 15 of title 11.

For further types of civil litigation that have been held to be core proceedings, *see* 1 *Collier on Bankruptcy*, P 3.02 (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. See *Howell Hydrocarbons v. Adams*, 897 F.2d 183, 189-90 (5th Cir. 1990) , *reh'g denied*, 1990 U.S. App. LEXIS 7689 (5th Cir. Apr. 25, 1990) (a core proceeding must involve a decision that ultimately affects the distribution of the debtor's assets); *Wood v. Wood (In re Wood)*, 825 F.2d 90, 97, 17 C.B.C.2d 743, 752 (5th Cir. 1987) ("a proceeding is core under section 157 if it invokes a substantive right provided by title 11 or if it is a proceeding that, by its nature, could arise only in the context of a bankruptcy case"). But see *PSINet, Inc. v. Cisco Sys. Capital Corp. (In re PSINet, Inc.)*, 2001 Bankr. LEXIS 1653, *82 (Bankr. S.D.N.Y. 2001) (declining to follow the *Wood* test).

(n8)Footnote 8. 28 U.S.C. § 157(c)(2).

(n9)Footnote 9. 28 U.S.C. § 157(c)(1).

(n10)Footnote 10. 28 U.S.C. § 157(e), as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). This amendment was intended to resolve the considerable controversy previously surrounding the issue of whether bankruptcy courts could conduct jury trials but since express consent is required it will have little effect in doing so.

(n11)Footnote 11. 28 U.S.C. § 1408(1).

(n12)Footnote 12. 28 U.S.C. § 1408(2).

(n13)Footnote 13. 28 U.S.C. § 1412.

(n14)Footnote 14. See *In re Suzanne De Lyon, Inc.*, 125 B.R. 863, 868 (Bankr. S.D.N.Y. 1991) . For further discussion of venue, see P 9.05 *infra*.

(n15)Footnote 15. 11 U.S.C. § 1108.

(n16)Footnote 16. 11 U.S.C. § 1104(a).

(n17)Footnote 17. Appointment of a trustee is generally considered an extraordinary remedy, and there is a strong presumption that the debtor should remain in possession. See *In re Sharon Steel Corp.*, 871 F.2d 1217, 1225-26 (3d Cir. 1989) ("[i]t is settled that the appointment of a trustee should be the exception, rather than the rule"); *In re Madison Mgmt. Group, Inc.*, 137 B.R. 275, 281-82 (Bankr. N.D. Ill. 1992) . However, the United States trustee shall request an appointment of a trustee if there are reasonable grounds to suspect that the then-current members of a debtor's governing body, including chief executive officer or chief financial officer or members of the governing body who selected such person, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting. 11 U.S.C. § 1104(e) (as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, and effective in cases filed on or after April 20, 2005).

(n18)Footnote 18. 11 U.S.C. § 1107.

(n19)Footnote 19. 11 U.S.C. § 363(b). Courts apply the business judgment test to transactions that are not in the ordinary course. See *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 1311, 12 C.B.C.2d 1202, 1209 (5th Cir. 1985) ; *In re Ionosphere Clubs, Inc.*, 21 C.B.C.2d 96, 103, 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989) (debtor in possession bears the burden of proving that a sale of property out of the normal course of business will aid the reorganization and is supported by a good business justification).

(n20)Footnote 20. 11 U.S.C. § 363(c).

(n21)Footnote 21. 11 U.S.C. § 1108.

(n22)Footnote 22. The bankruptcy court may order the formation of additional committees, including a committee

of equity security holders, upon a showing that such other committee is necessary to protect the interests of those who would be represented. 11 U.S.C. § 1102(a)(2). If a debtor is insolvent, the United States trustee and the bankruptcy court will not favor the formation of an equity security holder committee.

(n23)Footnote 23. When the debtor is a small business debtor (as defined in *section 101(51D) of the Bankruptcy Code*), the court may, on motion of a party in interest and for cause, order that a committee of creditors not be appointed. 11 U.S.C. § 1102(a)(3). A creditors' committee may be elected (but usually is not) in a chapter 7 liquidation case pursuant to *section 705 of the Code*.

(n24)Footnote 24. In 1991, the name of the Bankruptcy Rules was changed to the "Federal Rules of Bankruptcy Procedure." Subsequent references to the "Bankruptcy Rules" or the "Rules" in this book refer to the Federal Rules of Bankruptcy Procedure.

(n25)Footnote 25. See *Fed. R. Bankr. P. 2007* (Review of Appointment of Creditors' Committee Organized Before Commencement of the Case). *Fed. R. Bankr. P. 2007* allows for judicial review of any prepetition appointments on motion of a party in interest.

(n26)Footnote 26. The bankruptcy court may, after notice and a hearing, order the United States trustee to change the membership of a committee if the court finds that such a change is necessary to ensure adequate representation of creditors or equity security holders. 11 U.S.C. § 1102(a)(4) (added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and effective in cases filed on or after October 17, 2005).

(n27)Footnote 27. 11 U.S.C. § 1109(b).

(n28)Footnote 28. 11 U.S.C. § 1103(a). The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994, effective in cases filed on or after that date), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised), added 11 U.S.C. § 503(b)(3)(F), which provides that a member of a creditors' committee may be reimbursed for expenses which are incurred in the performance of the duties of the committee. See *Cargill Fin. Servs. Corp. v. Envirodyne Indus., Inc.*, 1995 U.S. Dist. LEXIS 10846 (N.D. Ill. July 10, 1995) (rejecting reimbursement of expenses to members of a creditors' committee in a case filed prior to the amendment to § 503); *but see First Merchants Acceptance Corp. v. J.C. Bradford & Co. (In re First Merchants Acceptance Corp.)*, 198 F.3d 394 (3d Cir. 1999) (authorizing reimbursement of attorneys' fees incurred by members of creditors' committee). Section 503(b)(4), as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, in effect codified the holding in *Cargill* by providing that committee members cannot be reimbursed for the attorneys' or accountants' fees incurred in connection with committee activities. See 11 U.S.C. § 503(b)(4) (excluding section 503(b)(3)(F), which otherwise allows committee members to recover expenses incurred in connection with committee activities). The fees incurred by individual committee members should not be confused with the fees incurred by a committee's retained professionals, which fees may generally be reimbursed once the bankruptcy court has approved such professionals' retention. See 11 U.S.C. §§ 328, 1103.

(n29)Footnote 29. See *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 268-69, 61 S. Ct. 493, 497, 85 L. Ed. 820, 825-26 (1941), *reh'g denied*, 312 U.S. 715, 61 S. Ct. 736, 85 L. Ed. 1145 (1941), (members of creditors' committee are fiduciaries).

(n30)Footnote 30. 11 U.S.C. § 1102(b)(3) (added by the 2005 Act).

(n31)Footnote 31. 11 U.S.C. § 1102(b)(3)(C).

(n32)Footnote 32. See *In re Federated Dep't Stores, Inc.*, 1991 Bankr. LEXIS 288 (Bankr. S.D. Ohio Mar. 7, 1991). See P 5.04[3][c] *infra* for a description of "Chinese wall" procedures adopted by a committee member in the *Federated* case.

(n33)Footnote 33. Pursuant to *section 1104(b)(1) of the Bankruptcy Code*, on the request of a party in interest made within 30 days of a court order directing the appointment of a trustee pursuant to section 1104(a), "the United States trustee shall convene a meeting of creditors for the purpose of electing one disinterested person to serve as trustee in the case." *11 U.S.C. § 1104(b)(1)*. Section 1104(b)(1) further provides that "[t]he election of a trustee shall be conducted in the manner provided in subsections (a), (b), and (c) of section 702 of this title." *Id.* If an eligible, disinterested trustee is elected at a meeting of creditors, then the United States trustee shall file a report certifying that election. Upon such filing the trustee is considered appointed, and the services of any other trustee appointed under subsection (d) are terminated. *See 11 U.S.C. § 1104(b)(2)(A)-(C)* (added by the 2005 Act).

(n34)Footnote 34. *11 U.S.C. § 1104(a)(1)*.

(n35)Footnote 35. *11 U.S.C. § 1104(a)(2)-(3)* (added by the 2005 Act).

(n36)Footnote 36. *11 U.S.C. § 1104(a)(1)-(3)*.

(n37)Footnote 37. *See In re Ionosphere Clubs, Inc.*, 22 C.B.C.2d 1583, 1587, 113 B.R. 164, 168 (Bankr. S.D.N.Y. 1990) .

(n38)Footnote 38. *In re Ionosphere Clubs, Inc.*, 22 C.B.C.2d 1583, 1587, 113 B.R. 164, 168 (Bankr. S.D.N.Y. 1990) ; *see also In re Sharon Steel Corp.* 871 F.2d 1217, 1226 (3d Cir. 1989) (decisions regarding the need for a trustee must be made on a case-by-case basis).

(n39)Footnote 39. *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 352-53, 105 S. Ct. 1986, 1992-93, 85 L. Ed. 2d 372, 380-81, 12 C.B.C.2d 651, 656-57 (1985) . The duties of the trustee in chapter 11 are set forth at *11 U.S.C. § 1106*.

(n40)Footnote 40. *11 U.S.C. § 1104(c)*. If the court orders an examiner, the United States trustee makes the appointment. *11 U.S.C. § 1104(d)*.

(n41)Footnote 41. *See In re Revco D.S., Inc.*, 898 F.2d 498, 500-01, 22 C.B.C.2d 841, 844-45 (6th Cir. 1990) .

(n42)Footnote 42. *See generally In re Oklahoma Ref. Co.*, 838 F.2d 1133, 18 C.B.C.2d 278 (10th Cir. 1988) .

(n43)Footnote 43. In a chapter 7 case, the United States trustee appoints an interim trustee promptly after entry of the order for relief. *11 U.S.C. § 701(a)(1)*. If requested by creditors who are entitled to vote under section 702(a) and who hold at least 20 percent in amount of the claims specified in section 702(a)(1), the creditors may elect a trustee. *11 U.S.C. § 702(b)*. If a trustee is not elected, the interim trustee appointed by the United States trustee serves as the trustee in the case. The duties of the chapter 7 trustee are set forth at § 704.

(n44)Footnote 44. *28 U.S.C. § 586(a)* (as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and effective in cases filed on or after October 17, 2005). *See also 1 Collier on Bankruptcy P 6.07* (Matthew Bender 15th Ed. Revised).



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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.05 Protecting the Debtor: The Automatic Stay of Section 362.

[1] The Key to the Process.

The automatic stay provision of section 362 is perhaps the Bankruptcy Code's most important means of effecting the twin policy goals of permitting financially troubled companies to reorganize and providing for equality of distribution among creditors.

The filing of a voluntary or involuntary petition for relief under any chapter of the Bankruptcy Code automatically operates as a stay of lawsuits and lien enforcements against the debtor. The purpose of the stay is to protect both the debtor and creditors. It gives breathing space to the chapter 11 debtor to stabilize its operations and prevents creditors who act first from obtaining payment for their claims to the detriment of other creditors.

[2] The Scope of the Stay.

The scope of the automatic stay is broad and may be applied against all entities, including, in certain circumstances, governmental units. The stay encompasses almost all judicial, administrative or other proceedings against the debtor; the enforcement of any judgment obtained before the commencement of the case; any act to obtain possession of property of the estate; any act to create, perfect or enforce a lien against property of the estate; any act to collect, assess or recover a claim against that debtor; and the setoff of any debt owing to the debtor.ⁿ¹

The automatic stay provisions only apply to debtors; nondebtor parties are not protected. However, some courts have enjoined parties from proceeding in state court against nondebtors (including officers, directors, affiliates, codefendants and guarantors) by invoking the general equitable powers conferred on them by *section 105 of the Bankruptcy Code*.ⁿ² Courts that have protected nondebtor parties have done so in circumstances where the continuation of the action against the nondebtor would affect property of the estate or impede the debtor's reorganization.ⁿ³ However, other courts have been unwilling to enjoin actions against nondebtor parties and the issue of the applicability of section 105 to such parties is not free from doubt.ⁿ⁴

[3] Exceptions to the Stay.

The exceptions to the automatic stay are set forth in section 362(b) and include the commencement or continuation of a criminal action or proceeding against the debtor; the commencement or continuation of an action by a governmental

unit to enforce its police or regulatory powers,ⁿ⁵ as well as conduct investigations or actions by certain securities self-regulatory agencies, such as the New York Stock Exchange or National Association of Securities Dealers, to enforce such organization's regulatory power or to enforce the organization's order or decision (other than for monetary sanctions); or actions to delist a security that does not meet applicable regulatory requirements.ⁿ⁶

[4] Duration of the Stay.

Unless lifted earlier, the stay with respect to any property of the estate continues until such property ceases to be property of the estate.ⁿ⁷ Subject to certain exceptions in cases filed by individuals,ⁿ⁸ unless a party moves against the stay and obtains relief, the stay of acts other than acts against property of the estate continues in effect until the earliest of (i) the time the case is closed; (ii) the time the case is dismissed; and (iii) the time a discharge is granted or denied.ⁿ⁹ In a chapter 11 case, discharge generally occurs upon confirmation of the plan of reorganization.

[5] Relief From the Stay.

A party in interest may apply for relief from the stay. If relief is warranted, the court may terminate, annul, modify or condition the stay.ⁿ¹⁰ Termination lifts the stay prospectively. Annulment, a rare remedy, retroactively validates an act taken in violation of the stay. Modifying or conditioning the stay is used to grant partial relief. The court may, for example, permit a creditor to commence an action against the debtor to reach the debtor's insurance carrier so long as the creditor does not take any steps to enforce the judgment directly against the debtor.

[a] Lack of Adequate Protection.

Section 362(d)(1) provides that the court may grant relief from the stay "for cause, including the lack of adequate protection of an interest in property of such party in interest."ⁿ¹¹ "Adequate protection" is an important concept in the Bankruptcy Code that also arises in other contexts, such as the debtor's right to use a secured creditor's collateral under section 363 and the debtor's attempt to borrow against already encumbered assets under section 364.

The Bankruptcy Code does not specify what kind of interest is entitled to adequate protection, but most cases involve a lien on property of the estate or a right of setoff. The value of the interest, not the amount of debt, is what is adequately protected. Thus, if the amount of the debt exceeds the creditor's interest in the property, the unsecured portion is not entitled to adequate protection.

Before the United States Supreme Court decided *United Savings Ass'n of Texas v. Timbers of Inwood Forest Associates, Ltd.*,ⁿ¹² there was a split of authority as to whether an "interest in property" protected by granting relief from the automatic stay on the ground of lack of adequate protection included an undersecured creditor's right to immediate foreclosure.ⁿ¹³ The Supreme Court held that the right to immediate foreclosure was not an "interest in property" protected by section 362(d) and that an undersecured creditor was not entitled to compensation for loss of opportunity costs caused by the automatic stay in foreclosing on its collateral.

[b] Types of Adequate Protection.

Section 361 provides three illustrations of court action designed to furnish adequate protection. First, the debtor can be ordered to provide the creditor with a single or periodic cash payments equivalent to the decrease in value of the creditor's interest in the property.ⁿ¹⁴ Second, the creditor may be granted an additional or replacement lien to the extent of the decrease in value of the creditor's interest in the collateral.ⁿ¹⁵ Third, the court may grant any other relief, except for granting the creditor an administrative expense claim under section 503(b)(1), that will result in the realization by the creditor of the "indubitable equivalent" of the creditor's interest in the property.ⁿ¹⁶

Perhaps the most common method of providing adequate protection is for the debtor to prove that the value of the collateral exceeds the value of the creditor's interest in the collateral. The amount of such an "equity cushion" can

provide adequate protection of the creditor's interest.ⁿ¹⁷ The method of valuation of the collateral is often an issue in such cases and courts have adopted different approaches based on the facts of each case.ⁿ¹⁸

FOOTNOTES:

(n1)Footnote 1. *See* 11 U.S.C. § 362(a)(1)-(8). *But see* *Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S. Ct. 286, 133 L. Ed. 2d 258, 33 C.B.C.2d 869 (1995) (temporary administrative hold placed on debtor's bank account was not tantamount to an exercise of the right to setoff and, thus, did not violate automatic stay).

(n2)Footnote 2. *See* *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 93-94, 18 C.B.C.2d 316, 322 (2d Cir.) , *cert. denied*, 488 U.S. 868, 109 S. Ct. 176, 102 L. Ed. 2d 145 (1988) ; *In re A.H. Robins Co.*, 880 F.2d 694 (4th Cir.) , *cert. denied sub nom. Menard-Sanford v. A.H. Robins Co.*, 493 U.S. 959, 110 S. Ct. 376, 107 L. Ed. 2d 362 (1989) ; *see also* *In re Chateaugay Corp.*, 109 B.R. 613, 621 (S.D.N.Y. 1990) ("[w]here an action taken outside the bankruptcy court threatens the reorganization, Section 105 permits the issuance of injunctive relief to effectuate the bankruptcy court's jurisdiction ... to administer the reorganization"), *appeal dismissed*, 924 F.2d 480 (2d Cir. 1991) .

(n3)Footnote 3. *See* *MacArthur Co. v. Johns-Manville Corp.*, 837 F.2d 89, 93, 18 C.B.C.2d 316, 322 (2d Cir.) , *cert. denied*, 488 U.S. 868, 109 S. Ct. 176, 102 L. Ed. 2d 145 (1988) ; *In re A.H. Robins Co.*, 880 F.2d 694, 701 (4th Cir. 1989) (third party actions may be enjoined when they "would affect the bankruptcy reorganization in one way or another such as by way of indemnity or contribution"); *In re Drexel Burnham Lambert Group, Inc.*, 960 F.2d 285, 293, 26 C.B.C.2d 1413 (2d Cir. 1992) ("[i]n bankruptcy cases, a court may enjoin a creditor from suing a third party, provided that the injunction plays an important part in the debtor's reorganization plan"), *cert. dismissed sub nom. Hart Holding Co. v. Drexel Burnham Lambert Group, Inc.*, 506 U.S. 1088, 113 S. Ct. 1070, 122 L. Ed. 2d 497 (1993) .

(n4)Footnote 4. *Lynch v. Johns-Manville Sales Corp.*, 710 F.2d 1194, 8 C.B.C.2d 1301 (6th Cir. 1983) ; *Williford v. Armstrong World Indus., Inc.*, 715 F.2d 124, 10 C.B.C.2d 569 (4th Cir. 1983) . *But see* *In re Eagle-Picher Indus., Inc.*, 963 F.2d 855 (6th Cir. 1992) (affirming the bankruptcy court's determination that irreparable harm would come to Eagle-Picher's reorganization efforts if an injunction protecting the nondebtor officers of the corporation were denied). The Circuit Courts also differ on whether releases and permanent injunctions of claims against nondebtor parties are permissible in some circumstances or whether *Bankruptcy Code* section 524(e) should be strictly construed as to not permit such releases or permanent injunctions. *See* *In re Greate Bay Hotel & Casino, Inc.*, 2000 Bankr. LEXIS 837, *15-16 (Bankr. D.N.J. 2000) .

(n5)Footnote 5. *See* 11 U.S.C. § 362(b)(1)-(28); *see also* *Board of Governors of Fed. Reserve Sys. v. MCorp Fin., Inc.*, 502 U.S. 32, 112 S. Ct. 459, 116 L. Ed. 2d 358, 25 C.B.C.2d 849 (1991) . The Supreme Court stated that the automatic stay provisions in section 362(a) do not have any application to "ongoing, nonfinal, administrative proceedings." If the enforcement proceedings of a *final* order affect the bankruptcy court's control over property of the estate, the bankruptcy court may then exercise its concurrent jurisdiction under 28 U.S.C. § 1334(b) to stay the proceedings. 502 U.S. 32, 39-41, 112 S. Ct. 459, 463-64, 116 L. Ed. 2d 358, 367-68, 25 C.B.C.2d 849, 855-56 (1991) .

(n6)Footnote 6. 11 U.S.C. § 362(b)(25), as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (enacted on April 20, 2005 and effective for cases filed on or after October 17, 2005). A securities self-regulatory organization is defined as a securities association registered with the Securities and Exchange Commission under Section 15A of the Securities Exchange Act of 1934 or a national securities exchange registered with the Securities and Exchange Commission under Section 6 of the Securities Exchange Act of 1934. 11 U.S.C. § 101(48A).

(n7)Footnote 7. 11 U.S.C. § 362(c)(1).

(n8)Footnote 8. 11 U.S.C. § 362(c)(3).

(n9)Footnote 9. 11 U.S.C. § 362(c)(2)(A)-(C).

(n10)Footnote 10. 11 U.S.C. § 362(d).

(n11)Footnote 11. 11 U.S.C. § 362(d)(1). Another ground for relief is provided in section 362(d)(2), which authorizes relief from the stay of an action against property if the debtor does not have an equity in the property and it is not needed for an effective reorganization. 11 U.S.C. § 362(d)(2). Further, section 362(d)(3), as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (enacted on April 20, 2005), provides for relief from the stay of an act against single asset real estate (as defined in *section 101(51B) of the Bankruptcy Code*) if, within 90 days after the filing of the petition, or 30 days after the court determines that the debtor is a single asset real estate debtor, whichever is later, the debtor has not filed a reorganization plan that has a reasonable possibility of being confirmed within a reasonable time, or commenced monthly payments to secured creditors. 11 U.S.C. § 362(d)(3). In addition, the relief from the stay of an act against real property by a creditor, whose claim is secured by an interest in such real property, may be granted if the court finds that the filing of the bankruptcy petition was part of a scheme to delay, hinder, and defraud creditors, if the scheme involved either transfer of all or part ownership or interest in such real property without the consent of the secured creditor or court approval, or multiple bankruptcy filings affecting the real property. 11 U.S.C. § 362(d)(4).

(n12)Footnote 12. 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) .

(n13)Footnote 13. The Court of Appeals for the Ninth Circuit had held that an undersecured creditor was entitled to compensation for the delay in enforcing its right to foreclose, separate and apart from compensation for diminution in value of the collateral. *In re American Mariner Indus.*, 734 F.2d 426, 435, 10 C.B.C.2d 910, 921 (9th Cir. 1984) . Other courts of appeals had taken the contrary view. *See In re Timbers of Inwood Forest Assocs., Ltd.*, 808 F.2d 363, 16 C.B.C.2d 1 (5th Cir. 1987) , *aff'd sub nom. United Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) ; *In re Briggs Transp. Co.*, 780 F.2d 1339, 13 C.B.C.2d 1289 (8th Cir. 1985) .

(n14)Footnote 14. 11 U.S.C. § 361(1).

(n15)Footnote 15. 11 U.S.C. § 361(2).

(n16)Footnote 16. 11 U.S.C. § 361(3). Thus, the court is given some flexibility in fashioning an order to provide adequate protection. *See generally 3 Collier on Bankruptcy*, P 361.03[4] (Matthew Bender 15th Ed. Revised). The concept of "indubitable equivalent" is derived from the case *In re Murel Holding Corp.*, 75 F.2d 941, 942 (2d Cir. 1935) . The concept has been modified since *Murel*. *See In re Mocco*, 1995 Bankr. LEXIS 17, *41 n.13 (Bankr. D.N.J. 1995) (citing *U.S. Sav. Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 377, 484 U.S. 365, 377, 98 L. Ed. 2d 740, 752, 108 S. Ct. 626, 633-34 (1988)) .

(n17)Footnote 17. *See In re Mellor*, 734 F.2d 1396, 1400, 10 C.B.C.2d 1353, 1357 (9th Cir. 1984) .

(n18)Footnote 18. The Supreme Court addressed valuation under section 506(a) in *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 37 C.B.C.2d 744 (1997) , with respect to reorganizations where the debtor seeks to continue to use the collateral over the objections of the secured party. In *Rash*, a chapter 13 case, the Court adopted the replacement value standard which it articulated as "the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." Several circuit courts had previously adopted the replacement value approach to valuation of collateral. *E.g.*, *In re Pembroke Manor Apts.*, 547 F.2d 805 (4th Cir. 1977) (going concern value); *In re Grant Broad. of Phila., Inc.*, 16 C.B.C.2d 1116, 71 B.R. 891 (Bankr. E.D. Pa. 1987) (cash flow valuation); *In re Phoenix Steel Corp.*, 39 B.R. 218 (D. Del. 1984) (the mean of liquidation and going concern values); *In re Stevens Enters., Inc.*, 148 F. Supp. 12 (E.D. Pa. 1957) (liquidation value).



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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.06 Facilitating the Continuing Operation of the Debtor.

[1] Use, Sale, and Lease of Property; § 363.

The policy goal of promoting the rehabilitation of a troubled company is best served by permitting continuation of its business affairs during the reorganization process. Operating the business necessarily involves the use of property of the estate, which is broadly defined in section 541(a) as including all legal and equitable interests of the debtor, wherever located and by whomever held. Section 363 defines the powers and duties of the debtor in possession concerning use of property of the estate and the rights of other parties that have interests in the property involved.

[a] Disposition of Property in the Ordinary Course of Business.

Section 363(c) permits the debtor, with some limitations, to use, sell or lease property of the estate in the ordinary course of business without notice or a hearing. The most important limitation is that such transactions must not involve property that is "cash collateral,"ⁿ¹ unless the debtor obtains the consent of each party that has an interest in such collateral or authorization from the court following notice and a hearing.ⁿ²

[b] Disposition of Property Not in the Ordinary Course of Business.

Subject to certain exceptions, following notice and a hearing, the court may authorize the debtor to use, sell or lease, other than in the ordinary course of business, property of the estate.ⁿ³ A sound business justification must be provided for the court to grant such an application.ⁿ⁴ Those opposing such a sale of property can object to it on the following grounds, among others: (i) that the alleged benefit to the estate is either non-existent or too speculative; (ii) that the transaction will benefit one group of creditors to the detriment of others; or (iii) that the transaction is an attempt to short-circuit the plan and confirmation process.ⁿ⁵

[c] Third-Party Interests.

The debtor is also limited in the use, sale or lease of property by section 363(e), which permits an entity that has an interest in the subject property to request that the court provide adequate protection of such interest. The court is empowered to act with or without a hearing.ⁿ⁶ Adequate protection may be provided in the manner described in section 361. The entity asserting the interest in property has the burden of proof on the issue of the validity, priority or extent of such interest, and the debtor has the burden of proof on the issue of adequate protection.ⁿ⁷

Section 363(f) sets forth the circumstances in which the debtor can sell property of the estate free and clear of any interest in the property. Generally, the interests attach to the proceeds of the sale, or adequate protection is furnished in some other way. Such a sale may proceed only if one of five conditions is met:

- (1) the sale is permitted by applicable nonbankruptcy law;
- (2) the entity with the interest in the property consents to the sale;
- (3) the third-party interest is a lien, and the sale price is greater than the aggregate value of all liens on the property;
- (4) the third-party interest is in *bona fide* dispute; or
- (5) the entity with the interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of the interest.ⁿ⁸

[2] Financing the Debtor; § 364.

The rehabilitation and continued operation of the financially troubled company often requires the infusion of additional capital to finance its operations. The prepetition bank line of credit will no longer be available and may have to be replaced by a new facility. Trade creditors will be extremely reluctant to continue to extend terms without some assurance that they will receive payment. Section 364 provides several methods for the debtor in possession to obtain credit after the commencement of the chapter 11 case.ⁿ⁹

[a] Obtaining Unsecured Credit in the Ordinary Course of Business.

The debtor in possession is permitted by section 364(a), unless the court orders otherwise, to obtain unsecured credit and incur unsecured debt in the ordinary course of business. The claim of a creditor who extends such credit is allowable under section 503(b)(1) as an administrative expense.ⁿ¹⁰

[b] Obtaining Unsecured Credit Not in the Ordinary Course of Business.

The court may also, after notice and a hearing, permit the debtor to obtain unsecured credit and incur unsecured debt other than in the ordinary course of business. Such a creditor's claim is also allowable as an administrative expense under section 503(b)(1).ⁿ¹¹ The granting of administrative expense priority may be sufficient to induce trade creditors to continue to extend normal credit to the debtor. If necessary, however, the debtor may apply for the granting of "superpriority status" pursuant to section 364(c) and (d).

[c] Obtaining Priority and Secured Debt.

Section 364(c) authorizes the obtaining of credit and the incurring of debt with some special priority. After notice and a hearing, the court may grant a prospective creditor any of the following: (1) priority over any and all administrative expenses specified in section 503(b)(1) or 507(b); (2) a lien on property of the estate that is not otherwise encumbered by a lien; or (3) a junior lien on property that is already encumbered by a lien.ⁿ¹²

[d] Obtaining Credit Through Granting Superpriority Liens.

When all other avenues for obtaining credit lead nowhere, the debtor may be able to obtain credit pursuant to section 364(d), which permits the court, after notice and a hearing, to grant a senior or equal lien, sometimes called a "priming lien," on property of the estate that is already subject to a lien. A section 364(d) application may be granted if (i) credit

cannot otherwise be obtained and (ii) the interest of the holder of the already-existing lien is adequately protected.ⁿ¹³ As in other contexts, the debtor in possession bears the burden of proof of adequate protection.ⁿ¹⁴

Section 364(e) provides protection for creditors who extend credit and receive in exchange a superpriority or priming lien when a party in interest appeals the order authorizing the extension of credit. Unless the appellant obtains a stay pending the appeal, the validity of the priority or lien so granted is not affected by the appeal or the reversal of the authorizing order, whether or not the creditor knew of the pendency of the appeal, if the credit was extended in good faith. Good faith, however, may not be presumed; the bankruptcy court must make an explicit finding that the creditor acted in good faith.ⁿ¹⁵

[3] Executory Contracts and Unexpired Leases; § 365.

Section 365(a) authorizes the debtor, subject to the court's approval, to assume or reject executory contracts or unexpired leases.ⁿ¹⁶ Section 365 promotes the policy goal of rehabilitation by permitting the debtor to reject contracts that impose burdensome liabilities while at the same time retaining those contracts that have favorable terms and are crucial to the reorganization of the debtor's business. The standard for determining whether to permit assumption or rejection is the "business judgment" test.ⁿ¹⁷

The Bankruptcy Code does not define "executory contract," but an executory contract is generally one under which performance remains due from each party to the contract.ⁿ¹⁸ Furthermore, section 365 applies only to true or *bona fide* leases and not to "financing" leases.ⁿ¹⁹ State law determines whether a lease is deemed to be a true lease or a security agreement.

The trustee may assume and assign most executory contracts and unexpired leases even when the agreement or applicable law prohibits such assignment.ⁿ²⁰ However, adequate assurance of future performance must be given by the assignee of the contract or lease, whether or not there has been a default.ⁿ²¹ Contracts or leases that the trustee is specifically prohibited from assuming or assigning include (i) a contract or lease when applicable law excuses the nondebtor party from accepting performance from or rendering performance to an entity other than the debtor or debtor in possession whether or not the contract or lease puts restrictions on assignment; or (ii) a contract to make a loan or extend debt financing or financial accommodations or to issue securities of the debtor.ⁿ²²

[a] Time for Assumption or Rejection.

In chapter 11, a contract or lease may be assumed or rejected at any time before confirmation of a plan except in the case of nonresidential real estate leases, which must be assumed or rejected within 120 days of the order for relief, unless the court extends the time for cause for an additional 90-day period.ⁿ²³ Any further extensions beyond 210 days require written consent of the lessor.ⁿ²⁴ If no action is taken, the lease is deemed rejected. Any party to an executory contract or residential lease may request that the court order the trustee to either assume or reject within a specified time.ⁿ²⁵

[b] Cure of Defaults and Adequate Assurances.

The decision to assume an executory contract or unexpired lease must be accompanied by: (i) a cure, or adequate assurance of a prompt cure, of all defaults (other than defaults resulting from the filing of a bankruptcy petition or the financial condition of the debtor);ⁿ²⁶ (ii) compensation, or adequate assurance of prompt compensation, to a nondebtor party to the contract or lease for actual pecuniary loss suffered by such party as a result of such default; and (iii) adequate assurance of future performance.ⁿ²⁷

[c] The Effect of Rejection.

The rejection of an unexpired lease or executory contract constitutes a breach of such lease or contract.ⁿ²⁸

If the contract or lease is not assumed, rejection constitutes breach as of the date immediately prior to the filing of the petition initiating the case, and the claim will be allowed and treated as a prepetition claim.ⁿ²⁹ If the contract or lease has been assumed under section 365 or under a plan of reorganization and rejection occurs *before* conversion to chapter 7, breach occurs as of the date of the rejection, and the claim will be treated as an administrative expense claim.ⁿ³⁰ If the contract or lease has been assumed under section 365 or under a plan of reorganization and rejection occurs *after* conversion, breach occurs as of the date immediately prior to conversion, and the claim will be treated as an administrative expense claim.ⁿ³¹ If the contract or lease has been assumed *after* the date of conversion, the breach occurs as of the date of rejection, and the claim will be treated as an administrative expense claim.ⁿ³²

FOOTNOTES:

(n1)Footnote 1. "Cash collateral" is broadly defined as:

cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in *section 552(b) of [the Bankruptcy Code]*, whether existing before or after the commencement of a case under [the Bankruptcy Code].

11 U.S.C. § 363(a).

(n2)Footnote 2. 11 U.S.C. § 363(c)(2).

(n3)Footnote 3. 11 U.S.C. § 363(b).

(n4)Footnote 4. See *In re Lionel Corp.*, 722 F.2d 1063, 1071, 9 C.B.C.2d 941, 950 (2d Cir. 1983) ; *In re Oneida Lake Dev., Inc.*, 23 C.B.C.2d 143, 148, 114 B.R. 352, 355-56 (Bankr. N.D.N.Y. 1990) (applying the relevant factors of the "Lionel test" to debtor's sale of substantially all of its assets pursuant to section 363(b)).

(n5)Footnote 5. See *In re Continental Air Lines, Inc.*, 780 F.2d 1223, 1227-28, 13 C.B.C.2d 1433, 1437 (5th Cir. 1986) ; compare *In re Braniff Airways, Inc.*, 700 F.2d 935, 939-40, 8 C.B.C.2d 522, 525-26 (5th Cir.) , *reh'g denied*, 705 F.2d 450 (5th Cir. 1983) (reversed district court's approval of sale of substantially all of debtor's assets because the sale had the practical effect of dictating the terms of the plan) with *In re Apex Oil Co.*, 92 B.R. 847, 866-74 (Bankr. E.D. Mo. 1988) (court approved sale of substantially all of debtor's assets because sale would permit debtors a unique opportunity for reorganization).

(n6)Footnote 6. 11 U.S.C. § 363(e).

(n7)Footnote 7. 11 U.S.C. § 363(p).

(n8)Footnote 8. 11 U.S.C. § 363(f).

(n9)Footnote 9. See P 9.08[6][b] *infra* for a thorough discussion of debtor in possession financing and P 6.06[2] *infra* for a discussion of debtor in possession financing in the context of prepackaged bankruptcies.

(n10)Footnote 10. 11 U.S.C. § 364(a).

(n11)Footnote 11. 11 U.S.C. § 364(b).

(n12)Footnote 12. 11 U.S.C. § 364(c).

(n13)Footnote 13. 11 U.S.C. § 364(d)(1).

(n14)Footnote 14. 11 U.S.C. § 364(d)(2).

(n15)Footnote 15. See *In re Revco D.S., Inc.*, 901 F.2d 1359, 1366, 22 C.B.C.2d 1263, 1273 (6th Cir. 1990) .

(n16)Footnote 16. Under section 365(n), a debtor may reject an executory contract under which it licenses intellectual property to another party, but the nondebtor/licensee has the choice of either treating the contract as terminated (giving rise to a breach of contract claim) or retaining its existing rights under the license agreement. 11 U.S.C. § 365(n).

(n17)Footnote 17. *Group of Institutional Investors v. Chicago, Milwaukee, St. Paul & Pac. R.R. Co.*, 318 U.S. 523, 63 S. Ct. 727, 87 L. Ed. 959 (1943) , *reh'g denied*, 318 U.S. 803, 63 S. Ct. 980, 87 L. Ed. 1166 (1943) ; see also *In re Minges*, 602 F.2d 38, 43, 20 C.B.C. 955 (2d Cir. 1979) .

(n18)Footnote 18. See Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973); see also H.R. Rep. No. 595, 95th Cong., 1st Sess. 347-350 (1977), *reprinted in* Vol. C Collier on Bankruptcy, Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 989, 95th Cong., 2d Sess. 58 (1978), *reprinted in* Vol. D Collier on Bankruptcy, Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n19)Footnote 19. See *In re PCH Associates*, 804 F.2d 193, 198-200 (2d Cir. 1986) ; see also *International Trade Admin. v. Rensselaer Polytechnic Inst.*, 936 F.2d 744, 24 C.B.C.2d 2123 (2d Cir. 1991) (a lease is not a *bona fide* lease for purposes of section 365 where the terms of the lease make the economic substance of the transaction closer to a sale than a lease). A financing lease is an arrangement that is nominally structured as a lease, but is in fact a mortgage or a secured loan subject to Article 9 of the Uniform Commercial Code. See also *In re Moreggia & Sons, Inc.*, 852 F.2d 1179, 19 C.B.C.2d 949 (9th Cir. 1988) (finding that a "lease agreement" was not a financing agreement, but rather a "peculiar" arrangement that created a property interest other than a *bona fide* leasehold; therefore, section 365 did not apply).

(n20)Footnote 20. 11 U.S.C. § 365(f)(1). See also *Robb v. Schindler*, 142 B.R. 589, 591 (D. Mass. 1992) ("Courts have consistently invalidated anti-assignment clauses in executory contracts and leases ..."); *In re David Orgell, Inc.*, 117 B.R. 574 (Bankr. C.D. Cal. 1990) (section 365 prohibits the enforcement of a provision in a long-term commercial lease that provides for a rent increase from a contract rate to a market rate in the event of assignment). But see *In re Claremont Acquisition Corp., Inc.*, 186 B.R. 977, 984 (C.D. Cal. 1995) , *aff'd sub nom. Worthington v. GMC (In re Claremont Acquisition Corp.)*, 113 F.3d 1029 (9th Cir. 1997) ("where federal or state statutory or common law prohibits assignment of certain types of agreements, even when these agreements are silent on the issue of assignment, it is appropriate to apply these laws in a bankruptcy proceeding"). See also 11 U.S.C. § 365(c)(1)(A).

(n21)Footnote 21. 11 U.S.C. § 365(f)(2).

(n22)Footnote 22. 11 U.S.C. § 365(c). Section 365(c) also specifies that the trustee cannot assume or assign a lease of nonresidential real property terminated under applicable nonbankruptcy law prior to the order for relief.

(n23)Footnote 23. 11 U.S.C. § 365(d)(4), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n24)Footnote 24. 11 U.S.C. § 365(d)(4)(B)(ii).

(n25)Footnote 25. 11 U.S.C. § 365(d)(2).

(n26)Footnote 26. These are known as *ipso facto* defaults.

(n27)Footnote 27. 11 U.S.C. § 365(b)(1).

(n28)Footnote 28. *11 U.S.C. § 365(g)*. In the cases of employees when the debtor is employer and landlords when the debtor is lessee, such claims are subject to certain limitations. *See 11 U.S.C. § 502(b)(6),(7)*.

(n29)Footnote 29. *11 U.S.C. § 365(g)(1)*.

(n30)Footnote 30. *11 U.S.C. § 365(g)(2)(A)*.

(n31)Footnote 31. *11 U.S.C. § 365(g)(2)(B)(i)*.

(n32)Footnote 32. *11 U.S.C. § 365(g)(2)(B)(ii)*.



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Collier Business Workout Guide

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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.07 Determining the Liabilities of the Estate.

[1] Purpose.

The Bankruptcy Code's method for determining the amount of liabilities that an estate has as well as the allowability and relative priority of such liabilities helps to promote the policy goal of treating creditors equally and fairly. The Bankruptcy Code's framework ensures that similarly situated creditors are treated equally with respect to a distribution of an estate's assets. Furthermore, the Bankruptcy Code "ranks" creditors depending on such factors as whether they hold liens or are entitled to administrative priorities.

[2] Definitions.

[a] What Is a Claim?

A "claim" is any right to payment, without regard to whether such a right is liquidated or unliquidated, fixed or contingent, matured or unmatured, disputed or undisputed, legal or equitable, secured or unsecured.ⁿ¹ An equitable remedy for breach of performance is a claim if such breach gives rise to a right of payment.ⁿ² Congress intended as broad a definition as possibleⁿ³ in order that all legal obligations of the debtor, no matter how remote or contingent, could be dealt with in the bankruptcy case.

[b] What Is an Interest?

An "interest" is not defined in the Bankruptcy Code, but the rights of an equity security holder are referred to as interests.ⁿ⁴ The Bankruptcy Code defines an equity security as a share in a corporation, a limited partnership interest or a warrant or right (other than a right to convert) to purchase, sell, or subscribe to a share, security or limited partnership interest.ⁿ⁵

[3] How is a Claim or Interest Asserted?

[a] Proof of Claim.

A claimant or interest holder asserts its right to payment by filing a proof of claim or a proof of interest.ⁿ⁶ The Bankruptcy Code itself provides little instruction as to the filing of a proof of claim, leaving the procedure to the

Federal Rules of Bankruptcy Procedure.

A proof of claim is "a written statement setting forth a creditor's claim."⁷ The proof of claim must conform substantially to the Official Form.⁸

Federal Rule of Bankruptcy Procedure 2002(a)(6) requires at least 20 days notice by mail by a party in interest of a hearing on such entity's request for compensation or reimbursement of expenses if the request exceeds \$1,000.⁹

Although section 501 is precatory, in a case under chapter 11, unless a claim or interest is listed in the schedule of liabilities filed pursuant to section 521(1), and is not listed as disputed, contingent or unliquidated, or the list of equity security holders filed pursuant to *Fed. R. Bankr. P. 1007(a)(3)*, a proof of claim is a prerequisite to the allowance of a claim.¹⁰ The schedule of liabilities and list of equity security holders constitute *prima facie* evidence of the validity and amount of listed claims and interests, unless such a claim is scheduled as disputed, contingent or unliquidated, and such scheduled creditors need not file proofs of claim.¹¹ A creditor whose claim is not scheduled or is scheduled as disputed, contingent or unliquidated must file a proof of claim or interest.¹²

[b] Bar Date.

The bankruptcy court in a chapter 11 case will set a "bar date," with certain exceptions, by which all proofs of claim or interest that require filing must be filed or be forever barred from recovery.¹³

[4] Allowance and Disallowance of Claims; § 502.

A proof of claim or interest executed and filed in accordance with the Bankruptcy Rules or deemed filed under section 1111(a) constitutes *prima facie* evidence of the validity and amount of the claim.¹⁴ Section 502(a) provides that such a claim or interest is deemed "allowed" unless a party in interest objects.¹⁵ If such an objection is made, the court, after notice and a hearing, determines the amount of the claim and allows the claim in such amount, subject to limitations enumerated in section 502(b).¹⁶

[a] Claims Relating to Unenforceable Contracts.

Section 502(b)(1) requires disallowance of any claim that is unenforceable against the debtor under any agreement or applicable law, for reasons such as usury, unconscionability or lack of consideration.¹⁷ A claim that is contingent or unliquidated, however, is not automatically disallowed, but will either be liquidated by the court or, if a liquidation would unduly delay the administration of the case, estimated for purposes of allowance under section 502(c)(1).¹⁸

[b] Unmatured Interest.

Section 502(b)(2) requires disallowance of a claim to the extent it includes unmatured interest as of the date of the petition. The amount of an unsecured creditor's claim is, therefore, fixed as of the date of the petition, and interest on unsecured and undersecured claims does not accrue during the chapter 11 case.¹⁹ The oversecured creditor of a solvent estate, however, is entitled to recover interest, fees, costs or charges provided for under the agreement or state statute under which the claim arose, to the extent that the value of such creditor's collateral covers principal and interest.²⁰ Unamortized original issue discount is considered unmatured interest.²¹

In the early 1990s, the Court of Appeals for the Second Circuit reversed a ruling by the bankruptcy court for the Southern District of New York which held that the amount by which the face value of a new debt security issued in an exchange offer exceeds the fair market value of the old debt security surrendered is considered original issue discount and, to the extent unamortized as of the petition date, it is disallowed as unmatured interest.²² The effect of the bankruptcy court's ruling has been substantially mitigated, but not eliminated. The Second Circuit limited its reversing opinion to the case of an exchange of like face amounts of debt securities and distinguished, and did not rule upon, an

exchange that results in a net reduction of outstanding debt and an exchange of outstanding equity securities for newly issued debt securities.ⁿ²³

[c] Leases of Nonresidential Real Property.

Section 502(b)(6) limits the amount of damages for termination of a lease allowable to a landlord of the debtor. The limitation is intended to prevent the landlord in a long-term lease from recovering a claim so large as to preclude other general unsecured creditors from recovering anything from the estate.ⁿ²⁴

A claim for damages for the termination of a lease is allowed only to the extent the claim does not exceed the rent under the lease for the greater of one year or 15 percent of the remaining term of the lease (not to exceed three years) following the date of the filing of the petition or the date on which the landlord retook possession of the property, whichever is earlier, plus any unpaid rent due under the lease, without acceleration, on that date.ⁿ²⁵

[d] Employment Contracts.

A claim for damages for termination of an employment contract is subject to similar limitations under section 502(b)(7). A claim for such damages is allowed only to the extent that the claim does not exceed the compensation due under the contract for the year following the date of filing or until the date of termination, whichever is earlier, plus unpaid compensation due, without acceleration, on the filing date.ⁿ²⁶

[5] Ranking Claims.

[a] Priority Claims.

Section 507 sets forth categories of claims that are entitled to priority in distribution and the order of such priority. Priority claims are entitled to be paid prior to other unsecured claims of the estate unless they are subordinated pursuant to section 510.ⁿ²⁷ If the estate does not have sufficient funds to satisfy a particular class of priority claims, then claimants within that class must share *pro rata*.ⁿ²⁸

Section 507 creates ten priorities in all. The first priority is given to domestic support obligations, including, among others, child support and alimony.ⁿ²⁹ Administrative expenses under section 503(b) and certain fees and charges assessed against the estate are accorded second priority.ⁿ³⁰ Third priority is given to so-called "involuntary gap creditors," who hold unsecured claims under section 502(f).ⁿ³¹ This provision relates to claims arising between the date of the filing of an involuntary bankruptcy petition and the order for relief or the appointment of a trustee.

Employee claims are treated as either fourth or fifth priority claims, depending on the nature of the claim. Fourth priority is given to unsecured claims for wages, salaries, or commissions, including vacation, severance and sick leave or for sales commissions earned by an individual or corporation with only one employee acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the debtor's business, earned within 180 days before the earlier of the date of the filing of the petition or the date of the cessation of the debtor's business, up to a maximum of \$10,950 per individual or corporation.ⁿ³² Fifth priority is given to unsecured claims for contributions to an employee benefit plan arising from services rendered within 180 days before the earlier of the commencement of the case or the cessation of the debtor's business. Fifth priority claims are limited to the maximum allowable amount of fourth priority claims (\$10,950 times the number of employees covered by the plan) minus the amount actually paid to employees as a result of fourth priority claims and with respect to any other employee benefit plan.ⁿ³³ Tax claims of governmental bodies are entitled to eighth priority.ⁿ³⁴ The remaining classes of priority claims are of lesser significance since they do not often come up in a context of business restructurings.ⁿ³⁵

[b] Subordination.

While section 507 creates a system of priorities, other Bankruptcy Code sections can affect and alter these priorities. For example, under section 510, a claim that is accorded priority can be subordinated, either by contractⁿ³⁶ or equitably,ⁿ³⁷ to another claim with a lower or no priority. Similarly, a nonpriority claim that would otherwise be entitled to receive a distribution prior to another nonpriority claim can also be subordinated.ⁿ³⁸

Under section 510(b), a claim arising from the rescission of a purchase or sale of a debtor's security for damages arising from such purchase or sale, or for reimbursement or contribution allowed under section 502 on account of such claim, is subordinated to all claims or interests that are senior or equal to the claim or interest.ⁿ³⁹ If the security is common stock the claim has the same priority as common stock.ⁿ⁴⁰

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 101(5)(A)*.

(n2)Footnote 2. *11 U.S.C. § 101(5)(B)*.

(n3)Footnote 3. *See Johnson v. Home State Bank, 501 U.S. 78, 111 S. Ct. 2150, 115 L. Ed. 2d 66, 24 C.B.C.2d 1171 (1991)*.

(n4)Footnote 4. The rights of a secured creditor in collateral are also referred to as interests.

(n5)Footnote 5. *11 U.S.C. § 101(16)*.

(n6)Footnote 6. *11 U.S.C. § 501*.

(n7)Footnote 7. *Fed. R. Bankr. P. 3001(a)*.

(n8)Footnote 8. *See Official Form 10, as amended in 2005*.

(n9)Footnote 9. *Fed. R. Bankr. P. 2002(a)(6)*, as amended effective December 1, 2000. The filing of proofs of claim is intended to give the debtor notice of the debt claimed by creditors.

(n10)Footnote 10. *Fed. R. Bankr. P. 3002(a)* states: "An unsecured creditor or an equity security holder must file a proof of claim or interest for the claim or interest to be allowed, except as provided in *Rules 1019(3), 3003, 3004 and 3005*." *Fed. R. Bankr. P. 3003(b)* provides the exception for claims listed in the schedule of liabilities or interests listed in the list of equity security holders.

(n11)Footnote 11. *Fed. R. Bankr. P. 3003(b)(1),(2)*.

(n12)Footnote 12. *11 U.S.C. § 1111(a); Fed. R. Bankr. P. 3003(c)(2)*.

(n13)Footnote 13. *Fed. R. Bankr. P. 3003(c)(3); Interim Rule 3003(c)(3)*. In a chapter 7 liquidation, a proof of claim must be filed within 90 days after the first set date for the meeting of creditors called pursuant to section 341(c), subject to certain exceptions.

(n14)Footnote 14. *Fed. R. Bankr. P. 3001(f)*.

(n15)Footnote 15. *11 U.S.C. § 502(a)*.

(n16)Footnote 16. *11 U.S.C. § 502(b)*. While the existence of a claim is determined solely by state law, the allowance or disallowance of a claim in bankruptcy is a matter of federal law left to the bankruptcy court's determination. *See In re Johnson, 960 F.2d 396, 26 C.B.C.2d 1054 (4th Cir. 1992)*.

(n17)Footnote 17. *See S. Rep. No. 989, 95th Cong., 2d Sess. 62 (1978), reprinted in Vol. D Collier on Bankruptcy,*

App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n18)Footnote 18. 11 U.S.C. § 502(c)(1).

(n19)Footnote 19. See *First Fidelity Bank, N.A. v. Midlantic Nat'l Bank (In re Ionosphere Clubs, Inc.)*, 26 C.B.C.2d 955, 960, 134 B.R. 528, 531 (Bankr. S.D.N.Y. 1991) ; see also *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 163, 67 S. Ct. 237, 240, 91 L. Ed. 162, 166 (1946) , *reh'g denied*, 329 U.S. 833, 67 S. Ct. 497, 91 L. Ed. 706 (1947) (reorganization under Chapter X of the former Bankruptcy Act; "interest on the debtors' obligations ceases to accrue at the beginning of proceedings").

(n20)Footnote 20. 11 U.S.C. § 506(b); see *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241-43, 109 S. Ct. 1026, 1030-31, 298-90, 20 C.B.C.2d 267, 271-72 (1989) (the language of section 506(b) is clear that only an oversecured creditor may recover postpetition interest from a debtor); see also *In re Sublett*, 895 F.2d 1381, 22 C.B.C.2d 868 (11th Cir. 1990) ; *In re Lapiana*, 909 F.2d 221, 23 C.B.C.2d 766 (7th Cir. 1990) (oversecured creditors have a right to postpetition interest and a bankruptcy court is not empowered to dissolve that right). *But see In re James Wilson Assoc.*, 965 F.2d 160, 26 C.B.C.2d 1673 (7th Cir. 1992) (court retains discretion over right to postpetition interest when oversecured creditor seeks to enforce lien so as to "fence off" entire property in which it has an interest from all other creditors).

(n21)Footnote 21. *In re Allegheny Int'l, Inc.*, 23 C.B.C.2d 71, 100 B.R. 247 (Bankr. W.D. Pa. 1989) .

(n22)Footnote 22. *In re Chateaugay Corp.*, 22 C.B.C.2d 530, 109 B.R. 51 (Bankr. S.D.N.Y. 1990) , *aff'd*, 130 B.R. 403 (S.D.N.Y. 1991) , *aff'd in part and rev'd in relevant part*, 961 F.2d 378, 26 C.B.C.2d 1174 (2d Cir. 1992) ; see also *In re Pengo Indus., Inc.*, 129 B.R. 104 (N.D. Tex. 1991) (reversing an order of the bankruptcy court that the issuance by one of the debtors of new debentures in exchange for a like face amount of its outstanding debentures gave rise to original issue discount), *aff'd*, 962 F.2d 543, 27 C.B.C.2d 119 (5th Cir.) , *cert. denied*, 506 U.S. 1000, 113 S. Ct. 602, 121 L. Ed. 2d 538 (1992) . See P 5.13[2] *infra* for a discussion of these decisions.

(n23)Footnote 23. *In re Chateaugay Corp.*, 961 F.2d 378, 382-83, 26 C.B.C.2d 1174, 1180 (2d Cir. 1992) .

(n24)Footnote 24. See *Oldden v. Tonto Realty Corp.*, 143 F.2d 916 (2d Cir. 1944) .

(n25)Footnote 25. 11 U.S.C. § 502(b)(6). To the extent the landlord has a security deposit in excess of the amount of his or her allowed claim, the excess is turned over to the estate. If the deposit is less than the allowed claim, the claim is divided into a secured portion and an unsecured portion. The landlord may not offset actual damages against the security deposit and then claim for the balance as an allowed claim; the security deposit will be applied in satisfaction of the entire allowed claim.

(n26)Footnote 26. 11 U.S.C. § 502(b)(7).

(n27)Footnote 27. 11 U.S.C. § 726. Section 726 provides that, absent subordination, an estate's assets are to be distributed in the following order: first, to priority claims under section 507; second, to unsecured claims with respect to which a timely proof of claim has been filed; third, to unsecured claims with respect to which a proof of claim was tardily filed; fourth, to payment of allowed claims for prepetition fines, penalties or forfeitures to the extent they are not compensatory for actual loss; fifth, in payment of interest on claims from the petition date; and, lastly, to the debtor. 11 U.S.C. § 726(a). See P 1.07[5][b] *infra* for a discussion of the subordination of claims.

(n28)Footnote 28. 11 U.S.C. § 726(b).

(n29)Footnote 29. 11 U.S.C. § 507(a)(1), as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8. Changes to section 507(a) take effect in cases filed on or after April 20, 2005.

(n30)Footnote 30. 11 U.S.C. § 507(a)(2).

(n31)Footnote 31. 11 U.S.C. § 507(a)(3).

(n32)Footnote 32. 11 U.S.C. § 507(a)(4), as amended by the 2005 Act. *Section 104(b)(1) of the Bankruptcy Code* provides for the adjustment of dollar amounts set forth in certain sections of the Bankruptcy Code every three years, beginning April 1, 1998. Most recently, section 507(a)(4) was amended to increase the claim amount to \$10,950 for cases commenced on or after April 1, 2007. In cases filed before April 1, 2007, the old amount (\$10,000 for cases filed on or after April 20, 2005) still applies. The priority for claims for sales commissions earned by independent contractors applies only if at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the debtor. 11 U.S.C. § 507(a)(4)(B).

(n33)Footnote 33. 11 U.S.C. § 507(a)(5). Section 507(a)(5) was amended to increase the claim amount to \$10,950 for cases commenced on or after April 1, 2007. In cases filed before April 1, 2007, the old amount (\$10,000 for cases filed on or after April 20, 2005) still applies.

(n34)Footnote 34. 11 U.S.C. § 507(a)(8), as amended by the 2005 Act.

(n35)Footnote 35. Sixth priority pertains to creditors of debtors that operate grain storage facilities or fish produce storage or processing facilities. 11 U.S.C. § 507(a)(6). Seventh priority is accorded unsecured claims of individuals, up to \$2,225 per individual, who deposit, before commencement of the case, money in connection with the purchase lease or rental of property or the purchase of services that were not delivered or provided. 11 U.S.C. § 507(a)(7). Section 507(a)(7) was recently amended to increase the amount to \$2,225. For cases commenced prior to April 1, 2004, the amount remains at \$2,100. A ninth priority pertains to allowed unsecured claims based upon any commitment by the debtor to a Federal depository institution's regulatory agency to maintain the capital of an insured depository institution. 11 U.S.C. § 507(a)(9). Tenth priority is given to claims for death or personal injuries resulting from the operation of a motor vehicle or vessel if such operation was unlawful because the debtor was intoxicated from using alcohol, a drug, or another substance. 11 U.S.C. § 507(a)(10), added by the 2005 Act.

(n36)Footnote 36. 11 U.S.C. § 510(a); *see In re Ionosphere Clubs, Inc.*, 134 B.R. 528, 533, 26 C.B.C.2d 955, 963 (Bankr. S.D.N.Y. 1991) (enforcement of subordination provisions is no longer solely an application of the court's equitable powers but is mandated by statute, and such provisions are to be as enforceable in bankruptcy as they are under nonbankruptcy law).

(n37)Footnote 37. 11 U.S.C. § 510(c); *see In re Fabricators, Inc.*, 926 F.2d 1458, 1464, 24 C.B.C.2d 1489, 1499 (5th Cir. 1991) (following the three-prong test for equitable subordination based on inequitable conduct enunciated in *In re Mobile Steel Co.*, 563 F.2d 692, 700 (5th Cir. 1977)). The principles regarding equitable subordination were developed by the courts prior to the enactment of the Bankruptcy Code, and were to serve as the basis for the application of section 510(c) in proceedings under title 11. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 359 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). For further discussion of equitable subordination in proceedings under the Bankruptcy Code, *see* P 4.07 *infra*.

(n38)Footnote 38. 11 U.S.C. § 726(a).

(n39)Footnote 39. 11 U.S.C. § 510(b).

(n40)Footnote 40. 11 U.S.C. § 510(b).



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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.08 Determining the Assets of the Estate.

[1] Property of the Estate; § 541.

The filing of a petition commencing a chapter 11 case creates an estate.ⁿ¹ The scope of the definition of "property of the estate" is broad: It includes all legal or equitable interests of the debtor in property, wherever located and by whomever held.ⁿ² It encompasses all kinds of property, including tangible or intangible property, causes of action or property recovered by the trustee under section 542. The debtor's interests in property include title to property, possessory interests and leasehold interests.

[2] Turnover of Property of the Estate; § 542.

Any entity in possession, custody or control of property that the debtor may use, sell or lease under section 363 is required to deliver to the debtor and account for such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.ⁿ³ Any entity that owes a debt to the debtor that is matured, payable on demand, or payable on order is required to pay such debt,ⁿ⁴ except to the extent that such entity has a valid right of setoff.ⁿ⁵

[3] Avoidance Actions.

[a] Trustee as Lien Creditor--The "Strong Arm" Powers of Section 544.

The Bankruptcy Code grants the chapter 11 debtor the power to seek to void certain prepetition liens and payments and have such property returned to the estate. This grant of power serves the policy goal of equitable distribution among creditors by maximizing the debtor's estate for the benefit of all creditors and equity security holders.

Under section 544(a), the trustee receives the rights and powers of a hypothetical creditor with a judicial lien on all property of the debtor as of the date of the petition (or who obtains a writ of execution that is returned unsatisfied) and a hypothetical *bona fide* purchaser of real property from the debtor as of the date of the petition.ⁿ⁶ These powers enable the trustee to avoid unperfected consensual liens for the benefit of the estate and its creditors. A judicial lien creditor has priority over an unperfected security interest pursuant to § 9-317(a)(2) of the *Uniform Commercial Code* (the "U.C.C."). If a security interest is not properly perfected in accordance with Article 9 of the U.C.C. at the time of the commencement of the case, the trustee may avoid the security interest.ⁿ⁷

[b] Preferential Transfers; § 547.

The trustee may avoid a transfer of property as a preferential transfer if five conditions are met.ⁿ⁸ First, the transfer, including a payment or granting of a lien, must be to or for the benefit of a creditor. Second, the transfer must be for or on account of an antecedent debt. Third, the transfer must have been made while the debtor was insolvent.ⁿ⁹ Fourth, the transfer must have been made during the 90 days immediately preceding the date of the filing of the petition or, if the creditor at the time of the transfer was an insider,ⁿ¹⁰ between 90 days and one year before the date of the filing of the petition.ⁿ¹¹ Fifth, the transfer must enable the creditor for whose benefit the transfer was made to receive more than the creditor would receive under a liquidating distribution pursuant to chapter 7.ⁿ¹²

Certain transactions are specifically excluded by section 547(c) from the trustee's avoiding power, such as contemporaneous exchanges for new value, any transfer of less than \$5,000 by a debtor whose debts are not primarily consumer debts, and certain transactions in the ordinary course of business.ⁿ¹³

[c] Fraudulent Conveyances; § 548.

Section 548 of the Bankruptcy Code embodies both a subjective fraud concept and an objective standard.ⁿ¹⁴ The subjective fraud concept is embodied in section 548(a)(1)(A), which permits the avoidance of transfers or obligations that were made or entered into with an actual intent to hinder, delay or defraud creditors.ⁿ¹⁵

The objective standard appears in section 548(a)(1)(B), which provides that transfers of property or obligations incurred by a debtor are deemed constructively fraudulent, notwithstanding the intent of the parties, if the debtor does not receive "reasonably equivalent value" and the debtor: (i) was "insolvent" or was rendered insolvent by the transfer; (ii) was engaged in business and as a result of the transfer retains "unreasonably small capital" to conduct its business; (iii) intended to incur, or believed that it would incur, debts that would be beyond its ability to pay as such debts matured; or (iv) made a transfer, or incurred an obligation to or for the benefit of an insider under an employment contract and not in the ordinary course of business.ⁿ¹⁶ Section 548(a)(1)(B) is designed to reduce subjective inquiries into the intent of the parties and to void transactions that are not intentionally fraudulent but are unfairly detrimental to creditors. A trustee may avoid a subjective or objective fraudulent transfer that was made within two years before the date of the filing of the petition.ⁿ¹⁷ Among recent developments has been the application of fraudulent conveyance law to failed leveraged buyouts.ⁿ¹⁸ Some creditors of companies that failed as a result of highly leveraged buyouts have successfully applied the fraudulent conveyance laws to avoid payments to shareholders or claims of financing lenders.ⁿ¹⁹

The trustee may also avoid a fraudulent transfer pursuant to section 544(b) and state fraudulent conveyance law.ⁿ²⁰ Section 544(b)(1) empowers the trustee to avoid any transfer that is voidable under nonbankruptcy law by an unsecured creditor who has an allowable claim. In most cases, the principal advantage of the state law as opposed to section 548(a)(1), which is subject to the two-year limitations period, is a longer statute of limitations available to creditors in chapter 11.ⁿ²¹

[d] Postpetition Transfers; § 549.

Section 549 permits the debtor to avoid any transfer of property that occurs after the commencement of the case, if the transfer was either unauthorized by the court or authorized solely by section 303(f) (transfers by the debtor between the time that an involuntary petition is filed and the order for relief is granted) or section 542(c) (transfers by a third party of property of the estate without actual notice or actual knowledge of the commencement of the case).ⁿ²² Section 549(b) protects "involuntary gap" transferees, that is, entities to whom property is transferred between the date of filing an involuntary petition and the date of the order for relief. Such transferees are protected to the extent of any value, including services, but excluding satisfaction of a debt that arose before the commencement of the case, given after the commencement of the case in exchange for the transfer. Notice to or knowledge of the transferee is irrelevant.ⁿ²³

The transfer of an interest in real property to a good faith purchaser without knowledge of the commencement of the case and for present fair equivalent value is also excluded, provided that a copy of the petition had not been filed before the transfer was perfected.ⁿ²⁴

An action under section 549 may not be commenced after the earlier of (1) two years after the date of the transfer sought to be avoided, and (2) the time the case is closed or dismissed.ⁿ²⁵

[e] Recovery From Transferees; § 550.

While other sections of the Bankruptcy Code describe the kinds of transfers of property that may be avoided by the trustee, section 550 describes the liability of transferees from whom the property in question, or if the court so orders, the value of the property, may be recovered. Section 550(a) permits the trustee to recover the property from the initial transferee, the entity for whose benefit such transfer was made, or any immediate or mediate transferee of such initial transferee.ⁿ²⁶ Section 550(b) limits the liability of the immediate or mediate transferee of the initial transferee if the second transferee takes for value (including satisfaction or securing of a present or antecedent debt in good faith), in good faith and without knowledge of the voidability of the transfer.ⁿ²⁷ This shield from liability extends to the immediate or mediate transferee of a protected transferee.

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 541(a)*.

(n2)Footnote 2. *11 U.S.C. § 541(a)(1)*.

(n3)Footnote 3. *11 U.S.C. § 542(a)*.

(n4)Footnote 4. *11 U.S.C. § 542(b)*.

(n5)Footnote 5. *11 U.S.C. § 542(b)*.

(n6)Footnote 6. *11 U.S.C. § 544(a)*.

(n7)Footnote 7. The section 544 avoiding powers are limited by any generally applicable law that permits perfection of an interest in property to be effective against an entity that acquires rights in such property before the date of perfection or that provides for the maintenance or continuation of perfection of an interest in property to be effective against an entity that acquires rights in such property before the date on which action is taken to effect such maintenance or continuation. *11 U.S.C. § 546(b)*. An example of such "relation-back" perfection rules is *U.C.C. § 9-317(e)*, which provides that a purchase money security interest that is perfected within a specified period after the debtor takes possession of the collateral takes priority over a creditor who obtains a lien between the time the security interest attaches and the time the security interest is perfected.

(n8)Footnote 8. *11 U.S.C. § 547(b)*.

(n9)Footnote 9. For the purposes of section 547, the debtor is presumed to have been insolvent on and during the 90 days immediately prior to the commencement of the case. *11 U.S.C. § 547(f)*.

(n10)Footnote 10. An "insider," in the context of a corporate debtor, is defined as a director, officer, a person in control of the debtor, a partnership in which the debtor is a general partner, a general partner of the debtor, or a relative of a general partner, director, officer or person in control of the debtor. *11 U.S.C. § 101(31)(B)*.

(n11)Footnote 11. The extended one-year preference period had been applied to third-party creditors who were not themselves insiders, but who held guaranties from insiders, including controlling shareholders. *See Levit v. Ingersoll*

Rand Fin. Corp. (In re Deprizio), 874 F.2d 1186, 22 C.B.C.2d 36 (7th Cir. 1989) ; *In re Erin Food Servs., Inc.*, 980 F.2d 792, 27 C.B.C.2d 1689 (1st Cir. 1992) (adopting the *Deprizio* rule). Section 202 of the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994 and effective in cases filed on or after that date), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised), amending section 550 of the Bankruptcy Code, overruled the *Deprizio* line of cases and made clear that noninsider transferees are not subject to the preference provisions of the Bankruptcy Code beyond the 90-day period. See 11 U.S.C. § 550(c). However, even after the 1994 amendment, several decisions held that section 550(c) did not overrule *Deprizio* completely. See, e.g., *Roost v. Associates Home Equity Servs., Inc. (In re Williams)*, 234 B.R. 801 (Bankr. D. Or. 1999) ; *Congress Credit Corp. v. AJC Int'l (In re Congress)*, 186 B.R. 555, 558 (D.P.R. 1995) (finding that the security interest was avoidable under the *Deprizio* rule even though recovery of a payment would have been precluded by section 550(c)). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended section 547 to clarify that a preferential transfer made by the debtor between 90 days and one year before the date of the filing of a bankruptcy petition to a noninsider for the benefit of a creditor that is an insider is avoidable only with respect to the insider and not with respect to noninsider third parties. 11 U.S.C. § 547(i) (effective for cases pending or commenced on or after April 20, 2005).

(n12)Footnote 12. 11 U.S.C. § 547(b).

(n13)Footnote 13. 11 U.S.C. § 547(c), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). In *Fidelity Fin. Servs., Inc. v. Fink*, 522 U.S. 211, 118 S. Ct. 651, 139 L. Ed. 2d 571, 38 C.B.C.2d 1155 (1998) , the Supreme Court held that a creditor may invoke the "enabling loan" exception of section 547(c)(3) only upon acting to perfect its interest within the 20 days after the debtor takes possession of the property, despite a state law relation back provision allowing for more time.

(n14)Footnote 14. The objective standard is based on the "badges of fraud" test, which was eliminated as a separate requirement for a finding of fraud by the Uniform Fraudulent Conveyance Act. See P 4.06[1] *infra*; see also *Max Sugarman Funeral Home, Inc. v. A.D.B. Investors*, 926 F.2d 1248, 1254, 24 C.B.C.2d 1414, 1422-23 (1st Cir. 1991) (it is permissible to "infer fraudulent intent from the circumstances surrounding the transfer, ... taking particular note of certain recognized indicia or badges of fraud").

(n15)Footnote 15. 11 U.S.C. § 548(a)(1)(A). The Religious Liberty and Charitable Donation Protection Act of 1998, Pub. L. No. 105-183, reprinted in Vol. F Collier on Bankruptcy, App. Pt. 41(o) (Matthew Bender 15th Ed. Revised), was enacted, effective June 19, 1998. The Act and the amendments made by the Act apply to any case brought under an applicable bankruptcy code section. The Act amends subsections 548(a)&(d) of the Code, affecting the ability of a bankruptcy trustee to avoid fraudulent transfers and obligations because a transfer of a charitable contribution to a qualified religious or charitable institution will not always be considered a fraudulent transfer. The amendments further prohibit the trustee from avoiding these charitable contributions when acting as lien creditor and successor to certain creditors and purchasers.

(n16)Footnote 16. 11 U.S.C. § 548 (a)(1)(B), as amended by Pub. L. No. 109-8 (2005).

(n17)Footnote 17. 11 U.S.C. § 548(a)(1). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 extended the reach-back period from one year to two years, effective for cases filed under title 11 more than one year after April 20, 2005, the date of the enactment of the Act. 11 U.S.C. § 548(a)(1). Pursuant to the 2005 Act, certain transfers to trusts intended to hide or fraudulently protect a debtor's assets, made within 10 years of the bankruptcy petition date, are also avoidable. 11 U.S.C. § 548(e).

(n18)Footnote 18. See P 4.06[2]-[4] *infra* for a discussion of fraudulent conveyance laws pertaining to leveraged buyouts.

(n19)Footnote 19. See, e.g., *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D. Pa. 1983) (superseded

by statute, 42 Pa. Con. Stat. Ann. § 5524(7)-see *Shields v. Secretary of Veterans Affairs*, 148 B.R. 783 (Bankr. E.D. Pa. 1993)) but only as to statute of limitations period for filing of actions in Pennsylvania claiming fraud or deceit; the period was reduced from six years to two years for actions arising after 1982), *aff'd sub nom. United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986), *cert. denied sub nom. McClellan Realty Co. v. United States*, 483 U.S. 1005, 107 S. Ct. 3229, 97 L. Ed. 2d 735 (1987); see also Final Report of Examiner Professor Barry Lewis Zaretsky, *In re Revco D.S., Inc.*, No. 588-1305, 588-1308 through 588-1321, 588-1761 through 588-1812 and 588-1820 (Bankr. N.D. Ohio 1990); Final Report of Examiner Sandra E. Mayerson, *In re Interco*, No. 91-4-00442-172 (Bankr. E.D. Mo. 1991).

(n20)Footnote 20. In Maryland, New York, Tennessee, Wyoming and in the Virgin Islands, the Uniform Fraudulent Conveyance Act (the "UFGA"), first adopted in 1918, still applies. The applicable statute in 41 states is now the Uniform Fraudulent Transfer Act, adopted by the Commissioners on Uniform State Laws in 1984 to replace the UFGA.

(n21)Footnote 21. 11 U.S.C. § 544(b)(1). The Religious Liberty and Charitable Donation Protection Act of 1998, Pub. L. No. 105-183, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(o) (Matthew Bender 15th Ed. Revised), was enacted, effective June 19, 1998. The Act and the amendments made by the Act apply to any case brought under an applicable bankruptcy code section. The Act amends *section 544(b) of the Code*. See n. 15 *supra*.

(n22)Footnote 22. 11 U.S.C. § 549(a).

(n23)Footnote 23. 11 U.S.C. § 549(b).

(n24)Footnote 24. 11 U.S.C. § 549(c).

(n25)Footnote 25. 11 U.S.C. § 549(d).

(n26)Footnote 26. 11 U.S.C. § 550(a). Section 550(c) provides that, if a transfer made between 90 days and one year before the filing of the petition is avoided under section 547(b) and was made for the benefit of a creditor who was an insider, the trustee may not recover from a transferee that is not an insider. 11 U.S.C. § 550(c).

(n27)Footnote 27. 11 U.S.C. § 550(b).



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Collier Business Workout Guide

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CHAPTER 1 Overview of Chapter 11 of the Bankruptcy Code

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P 1.09 Plan Formulation and Confirmation.

[1] Plan of Reorganization.

A plan of reorganization is a recapitalization plan. It provides for the discharge of prebankruptcy claims against the debtor and the distribution of either cash or securities of the reorganized entity to prebankruptcy creditors and equity security holders. The formulation of a final plan is the result of negotiations among the debtor, the creditors' committee and other parties in interest, which may include an equity security holders' committee, labor unions and governmental agencies.

[a] The Debtor's Exclusive Period; § 1121.

Perhaps the most powerful tool granted by the Bankruptcy Code to the debtor is control over the process of developing a plan of reorganization. Section 1121 grants the debtor the exclusive right to file a plan during the 120 days following the order for relief and, if the debtor files a plan within the 120-day period, it has 180 days from the order for relief to obtain the requisite acceptances of the plan.ⁿ¹ These periods can be extended or shortened by the court for cause, and are often extended in large complex reorganization cases.ⁿ² The bankruptcy court, however, may not extend the original 120-day period for filing a plan of reorganization beyond a date that is 18 months after the order for relief is entered. Additionally, the 180-day period for obtaining acceptances may not be extended beyond a date that is 20 months after the order for relief is entered.ⁿ³ Upon the expiration of the exclusive period and any extensions granted by the court, any party in interest, including the debtor, the trustee, the creditors' committee, the equity security holders' committee or any indenture trustee, may propose and file a plan.ⁿ⁴

The debtor bears the burden of proving that sufficient cause exists to justify the extension of the exclusive period.ⁿ⁵ Cause is generally found to exist if the debtor is a complex, multifaceted operation with substantial assets and liabilities.ⁿ⁶ However, an extension should be based on a showing of promise of probable success,ⁿ⁷ and should not be granted when it is sought merely as a delaying tactic or as a means of putting pressure on parties in interest to accept a plan they consider unacceptable.ⁿ⁸

[b] Elements of a Plan; § 1123.

Section 1123(a) sets forth those provisions which *must* be contained in a plan of reorganization. First, a plan must designate classes of claims and interests and provide for the same treatment of creditors in the same class, unless a

creditor votes to accept less favorable treatment or is part of a class of unsecured claims that has been subordinated pursuant to section 510(a).ⁿ⁹ Second, a plan must specify any class that is not impaired under the plan and the treatment to be accorded to any impaired class.ⁿ¹⁰ Third, a plan may not provide for the issuance of non-voting equity securities.ⁿ¹¹

Section 1123(b), on the other hand, describes those provisions which *may* be contained in a plan. First, a plan may impair or leave unimpaired any class of secured or unsecured claims.ⁿ¹² Second, a plan may provide for the assumption, rejection or assignment of any of the debtor's executory contracts or unexpired leases not previously rejected.ⁿ¹³ Third, a plan may provide for the settlement or adjustment of claims belonging to the debtor or the continuation of any litigation by the debtor or its representative.ⁿ¹⁴ Fourth, a plan may provide for the sale of all or substantially all of the estate's assets and the distribution of the proceeds from such sale among holders of claims or interests.ⁿ¹⁵ Fifth, a plan may modify the rights of holders of secured claims, other than a claim secured only by a security interest in real property that is the debtor's principal residence, or of holders of unsecured claims, or leave unaffected the rights of holders of any class of claims.ⁿ¹⁶

[c] Impairment; § 1124.

A class of claims or interests is impaired under a plan unless, with respect to each claim or interest of such class, the plan--

(1) leaves unaltered the legal, equitable, and contractual rights to which the holder of such claim or interest is entitled; or

(2) notwithstanding any contractual provision or applicable law that entitles the holder of such claim or interest to demand or receive accelerated payment after the occurrence of a default, cures any default that occurred before or after the commencement of the case, other than a default referred to in section 365(b)(2) or a default that section 365(b)(2) expressly does not require to be cured; reinstates the maturity of such claim or interest as such maturity existed before such default; compensates the holder for any damages incurred as a result of any reasonable reliance by such holder on such contractual provision or applicable law; if such claim or interest arises from any failure to perform a nonmonetary obligation, other than a default arising from failure to operate a nonresidential real property lease subject to section 365(b)(1)(A), compensates the holder of such claim or interest (other than the debtor or an insider) for any actual pecuniary loss incurred by such holder as a result of failure; and does not otherwise alter the legal, equitable or contractual rights to which the holder is entitled.ⁿ¹⁷

[2] Acceptance of a Plan.

[a] Classification of Creditors.

The claims of creditors and the interests of equity security holders are classified according to rank for purposes of voting and distributions under the plan. Claims or interests may be placed in the same class only if they are "substantially similar" to one another.ⁿ¹⁸ Creditors whose claims are secured by the same asset are generally classified together, as are administrative expense claims.

[b] Disclosure and Solicitation of Acceptance by Creditors; §§ 1125 and 1126.

A plan of reorganization is submitted to the classes of creditors for a vote. Before a vote is taken, each claimant or interest holder must receive a copy of the plan or a summary of the plan and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information.ⁿ¹⁹

A class that is not impaired is conclusively presumed to have accepted the plan and its vote is not required.ⁿ²⁰ Any

class for which no provision is made in the plan is deemed to have rejected the plan.ⁿ²¹ For an impaired class of creditors to accept a plan, a majority in number and two-thirds in amount of allowed claims voting must accept the plan.ⁿ²² For a class of impaired interests to accept a plan, two-thirds in amount of allowed interests must accept the plan.ⁿ²³

[3] Confirmation of a Plan; § 1129.

After the votes are cast, the court conducts a hearing to determine whether the plan can be confirmed. Any party in interest may object to confirmation.ⁿ²⁴ The court may confirm a plan only if all of the requirements of section 1129(a) are met.ⁿ²⁵ The import of the confirmation requirements is that a plan must be feasible and in the best interests of creditors.

[a] Feasibility.

"Feasibility" is a term of art which means that confirmation is not likely to be followed by liquidation or the need for further capital restructuring, unless liquidation or further reorganization are proposed in the plan.ⁿ²⁶ Feasibility requires the court to determine that the reorganized debtor's operations can support the new capital structure.

[b] Best Interests of Creditors.

One important aspect of reorganization under the Bankruptcy Code is the ability of a majority of an impaired creditor class to bind a dissenting minority. The Bankruptcy Code does not, however, abandon minority dissenters without protection. At a minimum, the plan must provide each creditor with the value it would receive in a chapter 7 liquidation.ⁿ²⁷ In order to demonstrate that this requirement has been satisfied, a debtor will typically include a liquidation analysis in its plan.

[c] Cramdown; § 1129(b).

If an impaired class of creditors or equity security holders votes against a plan that otherwise meets all of the requirements of section 1129(a), the court may still confirm the plan, if all of the requirements of the "cramdown" provision of section 1129(b) are met. Essentially, the court must find that the plan is "fair and equitable" with respect to the dissenting class and that it does not discriminate unfairly.ⁿ²⁸

"Fair and equitable" means that the dissenting class may insist on its legal priority relative to other classes of creditors and shareholders. This so-called "absolute priority rule" requires that members of the dissenting class receive in full the allowed amounts of their claims if any class junior to the dissenting class receives any distribution.ⁿ²⁹

Prior to the enactment of the Bankruptcy Code, a number of courts had recognized an exception to the absolute priority rule, which allowed junior creditors or equity holders to retain or acquire an equity interest in the reorganized debtor if they contributed new capital to the reorganized entity.ⁿ³⁰ However, the continuing validity of such exception after the enactment of the Bankruptcy Code is unclear. When the Supreme Court was presented with a case raising the question of the "new value" exception's continuing validity in the late 1990s, the Court declined to rule squarely on the issue. Instead, the Court held that the debtor's plan of reorganization violated the absolute priority rule because the equity holders of the debtor had received something of value "on account of their junior interest[s]."ⁿ³¹ The Court in *Bank of America National Trust and Savings Ass'n v. 203 North LaSalle Street Partnership* ruled that when the equity holders were given an exclusive opportunity to obtain the ownership interest in the reorganized debtor without any "market test" for the adequacy of the proposed purchase price, the absolute priority rule was violated. The Court, however, declined to explain what type of "market test" would be sufficient to satisfy the absolute priority rule.

Subsequently, a few lower courts have attempted to better define the nature of the market test required by the Supreme Court in *North LaSalle*. These discussions have generally focused on either some type of public auction or termination

of exclusivity permitting the filing of competing plans of reorganization.ⁿ³²

[4] The Effect of Confirmation of the Plan.

Discharge provides the debtor with a fresh start. The confirmation of a plan discharges the debtor from any debt that arose before the date of confirmation whether or not a proof of claim was filed or deemed filed, whether or not the claim was allowed, and whether or not the holder of the claim accepted the plan.ⁿ³³

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 1121(b)&(c)*. The debtor does not enjoy an exclusive period in cases in which a trustee has been appointed. *11 U.S.C. § 1121(c)(1)*. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005) (effective in cases filed on or after October 17, 2005), amended subsection 1121(e), which now provides that, in the case of a small business debtor, the debtor has the exclusive right to file a plan during the 180 days following the order for relief, unless the bankruptcy court, after notice and a hearing, extends the exclusivity period or, for cause, orders otherwise. Subsection 1121(e) also requires that the plan and a disclosure statement, if any, be filed within 300 days following the order for relief. *11 U.S.C. § 1121(e)(1)-(2)*. The court may extend the relevant time periods only if the small business debtor demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time, that a new deadline is imposed at the time the extension is granted, and the order extending time is signed before the existing deadline has expired. *11 U.S.C. § 1121(e)(3)*.

In a "prepackaged" bankruptcy, the debtor will file a plan and acceptances simultaneously with the petition commencing the case. *See 11 U.S.C. § 1121(a)*. *See PP 6.02, 6.03[3] infra* .

(n2)Footnote 2. *11 U.S.C. § 1121(d)*. A bankruptcy court order extending or shortening the debtor's 120-day exclusive period or the 180-day period for gaining acceptances is an interlocutory order. Before the passage of the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994, and *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised)) appeal of such an order could be made only with leave of the district court under *28 U.S.C. § 158*. Section 158 provides for an immediate appeal as of right to the district court from a bankruptcy court order extending or shortening the 120-day or 180-day periods. *See 28 U.S.C. § 158(a)(2)*. The 2005 Act added the ability of the parties to directly appeal final judgments, orders, and decrees to the court of appeals. *28 U.S.C. § 158(d)(2)*. The court, upon request from the parties or on its own motion, can certify the direct appeal to the court of appeals if the judgment, order, or decree involves either (1) a novel question of law or a matter of public importance; (2) a question of law requiring resolution of conflicting decisions; or (3) an immediate appeal that may materially advance the progress of the case or proceeding. *28 U.S.C. § 158(d)(2)(A)(i)-(iii)*. The court of appeals has discretion as to whether to accept the direct appeal. *28 U.S.C. § 158(d)(2)(A)*.

(n3)Footnote 3. *11 U.S.C. § 1121(d)*. Prior law did not impose any limits on the number or length of extensions, and, in practice, courts were extremely lenient in extending the exclusivity period. The amendments end this practice of freely granting extensions by limiting the court's ability to extend the debtor's exclusivity period.

(n4)Footnote 4. *11 U.S.C. § 1121(c)*.

(n5)Footnote 5. *In re Sharon Steel Corp.*, 78 B.R. 762, 765 (Bankr. W.D. Pa. 1987) .

(n6)Footnote 6. *See* H.R. Rep. No. 595, 95th Cong., 1st Sess. 232 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. *See* S. Rep. No. 989, 95th Cong., 2d Sess. 118 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n8)Footnote 8. *Id.* Thus, a court will look closely at all of the circumstances of the case, and not merely its size, in determining whether multiple extensions should be granted. *See, e.g., In re Texaco, Inc.*, 17 C.B.C.2d 169, 76 B.R. 322 (Bankr. S.D.N.Y. 1987) .

(n9)Footnote 9. 11 U.S.C. § 1123(a)(1), (4).

(n10)Footnote 10. 11 U.S.C. § 1123(a)(2), (3).

(n11)Footnote 11. 11 U.S.C. § 1123(a)(6). In addition, a plan must provide for the means of implementing its provisions, such as retention by the debtor of any part of the property of the estate, transfer or sale of all or part of the property of the estate to one or more entities, merger or consolidation of the debtor, satisfaction or modification of any liens, cancellation or modification of any indenture, curing or waiving of any default, extension of a maturity date or a change in an interest rate, amendment of the debtor's charter or issuance of the debtor's securities. 11 U.S.C. § 1123(a)(5). Furthermore, a plan can only contain provisions that are consistent with the interests of creditors and equity security holders and with public policy with respect to the manner of selection of any officer, director or trustee under the plan. 11 U.S.C. § 1123(a)(7).

(n12)Footnote 12. 11 U.S.C. § 1123(b)(1).

(n13)Footnote 13. 11 U.S.C. § 1123(b)(2).

(n14)Footnote 14. 11 U.S.C. § 1123(b)(3).

(n15)Footnote 15. 11 U.S.C. § 1123(b)(4). *See* PP 7.04[3][d] and 1.09[1][c] *infra* for a discussion of impairment.

(n16)Footnote 16. 11 U.S.C. § 1123(b)(5). In addition, a plan may also contain any provision not inconsistent with chapter 11 of the Code. 11 U.S.C. § 1123(b)(6).

(n17)Footnote 17. 11 U.S.C. § 1124 (as amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, and effective in cases filed on or after October 17, 2005). The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised), deleted paragraph (3) of section 1124, which provided that a class of claims or interests is unimpaired (and therefore not entitled to vote on the plan) if the plan provides for the payment in cash on the effective date of the allowed amount of the claim. This deletion was made to avoid the result reached in *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D.N.J. 1994) , in which the court found that unsecured creditors of a solvent debtor who were paid the allowed amount of their claims in cash on the effective date of the plan were not entitled to postpetition interest because their claims were unimpaired under section 1124(3). 140 Cong. Rec. H10768 (daily ed. October 4, 1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised). The effect of the deletion of paragraph (3) is to permit creditors who are not paid postpetition interest to vote against the plan. A plan can be confirmed over the vote of a dissenting creditor only if it meets the "best interests of creditors" test under section 1129(a)(7) of the Bankruptcy Code. The best interests of creditors test requires that a dissenting creditor receive or retain under a plan property with a value not less than the amount the creditor would receive or retain if the debtor were liquidated under chapter 7 of the Code. Section 726 provides that in a liquidation case under chapter 7 creditors receive postpetition interest before equity holders participate in any recovery. 11 U.S.C. § 726.

(n18)Footnote 18. 11 U.S.C. § 1122(a).

(n19)Footnote 19. 11 U.S.C. § 1125(b). "Adequate information" means "information of a kind, and in sufficient detail, as far as is reasonably practicable ..., that would enable [a hypothetical investor typical of the holders of claims or interests] of the relevant class to make an informed judgment about the plan." 11 U.S.C. § 1125(a)(1). Adequate information, however, "need not include such information about any other possible or proposed plan and in determining

whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information." *11 U.S.C. § 1125(a)(1)* (as amended by the 2005 Act). An "investor typical of holders of claims or interests of the relevant class" means an "investor having ... a claim or interest of the relevant class; ... such a relationship with the debtor as the holders of other claims or interests of such class generally have; and ... such ability to obtain such information from sources other than the disclosure required by [section 1125] as holders of claims or interests in such class generally have." *11 U.S.C. § 1125(a)(2)*.

In the case of a small business debtor, the court may determine that the plan itself provides adequate information and that a separate disclosure statement is not necessary, or that a disclosure statement submitted on standardized court-approved forms is acceptable. *11 U.S.C. § 1125(f)(1)-(2)*. The court may, subject to certain time constraints, also conditionally approve the disclosure statement after notice and a hearing and acceptances and rejections of a plan may be solicited based on the conditionally approved disclosure statement if the debtor provides adequate information to each holder of a claim or interest that is solicited. *11 U.S.C. § 1125(f)(3)*. In a "prepackaged" title 11 case, the debtor can continue to solicit acceptances or rejections to the plan post-petition if the solicitation pre- and post-petition complies with applicable nonbankruptcy law (i.e., the securities laws). *11 U.S.C. § 1125(g)* (added by the 2005 Act and effective in cases filed on or after October 17, 2005).

(n20)Footnote 20. *11 U.S.C. § 1126(f)*.

(n21)Footnote 21. *11 U.S.C. § 1126(g)*.

(n22)Footnote 22. *11 U.S.C. § 1126(c)*.

(n23)Footnote 23. *11 U.S.C. § 1126(d)*.

(n24)Footnote 24. *11 U.S.C. § 1128*.

(n25)Footnote 25. Section 1129(a), as amended by the 2005 Act, lists the following requirements for confirmation:

- (1) the plan complies with applicable provisions of the Code;
- (2) the proponent of the plan complies with applicable provisions of the Code;
- (3) the plan has been proposed in good faith and not by means forbidden by law;
- (4) any payment made or to be made by the proponent, by the debtor, or by a person issuing securities or acquiring property under the plan, for services or costs in connection with the case has been approved by the Court as reasonable;
- (5) the proponent of the plan has disclosed the identity and affiliation of any individual proposed to serve after confirmation of the plan as a director, officer or voting trustee of the debtor, an affiliate or successor, and (i) the appointment or continuance in such office of such individual is consistent with the interests of creditors and equity security holders and public policy, and (ii) the proponent of the plan has disclosed the identity of any insider to be employed by the reorganized debtor and the nature of any compensation of such insider;
- (6) any governmental regulatory commission with jurisdiction over the rates of the debtor has approved any rate change provided for in the plan, or such rate change is expressly conditioned on such approval;

(7) with respect to each impaired class of claims or interests, each holder has accepted the plan or will receive property of a value that is not less than the amount that such holder would receive if the debtor were liquidated under chapter 7 of the Code; or, as to those creditors who have elected under section 1111(b)(2) to have their claims allowed only as secured claims, each holder will receive property having a value not less than the value of each creditor's interest in the estate's interest in the property securing such claim;

(8) each class has accepted the plan or is not impaired under the plan;

(9) claims of the kind specified in sections 507(a)(2) and 507(a)(3) will receive, on the effective date of the plan, cash equal to the allowed amount of such claims. Priority claims under sections 507(a)(1),(4)-(7), if they have accepted the plan, will receive deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amount of such claim, or, if such class has not accepted the plan, will receive cash on the effective date of the plan equal to the allowed amount of such claim. Tax claims under section 507(a)(8), whether or not accepting the plan, will receive regular installment payments in cash (i) of a total value, as of the effective date of the plan, equal to the allowed amount of such claim; (ii) over a period that does not exceed five years after the date of the order for relief in the debtor's bankruptcy case; and (iii) in a manner that is not less favorable than the most favored nonpriority unsecured claim provided by the plan (other than cash payments made to a convenience class under *section 1122(b) of the Bankruptcy Code*);

(10) if a class of claims is impaired under the plan, at least one class of impaired claims has accepted the plan, excluding acceptance by any insider;

(11) confirmation of the plan is not likely to be followed by liquidation or the need for further reorganization of the debtor or successor to the debtor, unless such liquidation or reorganization is proposed in the plan;

(12) all fees payable under 28 U.S.C. § 1930 have been paid or the plan provides for the payment of all such fees on the effective date;

(13) the plan provides for the continuation after its effective date of payment of all retiree benefits at the level established under section 1114 at any time prior to confirmation of the plan, for the duration of the period the debtor has obligated itself to provide such benefits;

(14) all transfers of property of the plan are made in accordance with applicable nonbankruptcy law that governs the transfer of property by a corporation or trust that is not a moneyed, business, or commercial corporation or trust.

Certain additional requirements under section 1129(a) are generally not applicable in cases where the debtor is not an individual.

(n26)Footnote 26. *See 11 U.S.C. § 1129(a)(11).*

(n27)Footnote 27. *11 U.S.C. § 1129(a)(7).*

(n28)Footnote 28. *11 U.S.C. § 1129(b)(1); see P 7.04[3][d] infra* for a discussion of cramdown.

(n29)Footnote 29. *11 U.S.C. § 1129(b)(2).*

(n30)Footnote 30. *Case v. Los Angeles Lumber Prods. Co., 308 U.S. 106, 60 S. Ct. 1, 84 L. Ed. 110 (1939) .*

(n31)Footnote 31. *Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C. 2d 526 (1999) .

(n32)Footnote 32. See *In re Global Ocean Carriers Ltd.*, 251 B.R. 31 (Bankr. D. Del. 2000) (holding that the market test can be satisfied by either terminating the exclusive period to enable another party to file a competing plan or allowing others to bid for the equity pursuant to the debtor's plan); *In re Situation Mgmt. Sys.*, 252 B.R. 859 (Bankr. D. Mass. 2000) (holding that allowing a competing plan is preferable to providing for an auction process in the debtor's plan); *In re CGE Shattuck, LLC*, 1999 Bankr. LEXIS 1880 (Bankr. D.N.H. 1999) (holding that the appropriate market test should be determined on a case-by-case basis, but will usually involve either competing plans or an opportunity for third parties to bid for the new equity).

(n33)Footnote 33. 11 U.S.C. § 1141(d)(1). Confirmation of a plan does not discharge a debtor if the plan is a liquidating plan, the debtor does not engage in business after consummation of the plan, and the debtor would be denied a discharge in a liquidation case under *section 707(b) of the Code*. 11 U.S.C. § 1141(d)(3). An amendment to *Fed. R. Bankr. P. 4004(c)*, effective December 1, 2002, provides that discharge will not be granted while a motion requesting an extension of time to file a motion to dismiss the case under section 707(b) is pending.



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P 2.01 Introduction.

When first retained, restructuring counsel is likely to be confronted by a company in crisis. Unprepared for the financial distress in which they find themselves, most troubled companies move from emergency to emergency. Overwhelmed, they fail to focus on long-term needs. Central planning questions are ignored. Basic organizational steps are not taken. In addition, the deluge of threats and demands stimulated by news of the company's distress leaves many companies feeling beleaguered. In this state, they may make strategic errors. Excessive concessions are offered. Short-term solutions are pursued. Confronted with a company in such a crisis, it is the task of counsel (in conjunction with the troubled company's other professional advisors) to bring order from the chaos.



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P 2.02 Scope and Use of This Chapter.

This chapter focuses on the two paramount issues facing counsel to a company in the initial throes of financial distress. First, what course of action should the company select? Should it liquidate or reorganize? If reorganization is preferable, is it best pursued in a "workout" or under the supervision and protection of the bankruptcy court? Second, how should the company initiate its pursuit of the selected goal? What are the initial steps in the restructuring?

This chapter is divided into three parts. The first part of this chapter will discuss the question of whether the troubled company can be rehabilitated or must be liquidated. The second part of this chapter examines an issue which dominates the early days of the troubled company's restructuring and to which the company and its advisors must return repeatedly during the entire course of the restructuring, should the company be restructured in an out-of-court restructuring or in a case under the Bankruptcy Code. The final part of this chapter will discuss how, once a course of action has been selected, the troubled company commences the restructuring.



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P 2.03 Can the Debtor Be Rehabilitated?

The first issue confronting a company considering an out-of-court restructuring is one of feasibility. Can the debtor be rehabilitated? If rehabilitation is an impossibility, an out-of-court restructuring will not make sense and the company should consider other options, including liquidation under chapter 7 of the Bankruptcy Code or under comparable provisions of applicable state law.

[1] Is the Debtor Viable?

The pivotal issue in determining whether a company can be rehabilitated is the long-term viability of its business. Is the company now profitable on an operating basis? If not, can the company be restored to profitability given sufficient time and resources? If neither of these questions can be answered in the affirmative, the company is probably not a candidate for reorganization. A company that is not capable of generating operating profits lacks "going-concern" value. It is the preservation of going-concern value that is the principal justification for the expenditure of time and money required to rehabilitate a troubled company. In its absence, the company's creditors, shareholders and other constituencies will probably be best served by a speedy liquidation.

[2] Can the Debtor Afford the Costs of Rehabilitation?

Even when management of a troubled company believes that the company's business can be restored to profitability over time, the company's situation may be so precarious that when the costs of rehabilitation are factored into the analysis, rehabilitation is not a viable option. Both out-of-court restructurings and bankruptcy reorganizations impose substantial financial and other costs. Unless the troubled company possesses the resources to withstand these stresses, it will not survive the restructuring process and is not a candidate for rehabilitation.

[a] Financial Costs of Rehabilitation.

The monetary costs that the troubled company must bear during the period of its restructuring are generated primarily by its operations. While the company may be able to reduce certain non-essential expenses such as capital expenditures, the restructuring will not provide it with any respite from the majority of its operating expenses. It will have to continue to meet its payroll, pay the expenses of maintaining its plant and other assets, satisfy its tax liabilities and meet its other ordinary-course-of-business obligations. In fact, in a number of important respects, the demands of the restructuring may increase these expenses. Trade creditors may impose more restrictive credit terms and, in some cases, even refuse

to provide goods or services except on a "cash and carry" basis. Similarly, the employee-related expenses may increase during the period of the restructuring if, in order to retain essential personnel, financial inducements in the form of bonuses, enhanced severance and other improved employee benefit programs must be offered.

The restructuring (whether out-of-court or in chapter 11) will also impose entirely new expenses upon the troubled company. A company seeking to restructure will require the services of counsel and, depending on its size and complexity, accountants, investment bankers, crisis managers, public relations consultants and other specialists. In addition, in many cases, the troubled company will be compelled by the requirements of the Bankruptcy Code,ⁿ¹ its contractual obligations or the dynamics of the restructuring to bear the costs of the counsel and financial advisors retained by its major creditors. The fees and expenses of these professionals can be very substantial. In a large and complicated out-of-court restructuring, these costs can easily exceed one million dollars per month. In a bankruptcy case, they may be significantly higher.ⁿ²

[b] Other Costs of Rehabilitation.

A restructuring will also impose non-financial burdens on the troubled company, and in many cases, these burdens are more difficult for the company to withstand. Almost invariably, news of the company's financial problems and its efforts to restructure will be disseminated rapidly among its employees. Often, the size or importance of the company will give rise to publicity that will spread the news more widely.

Publicity concerning the company's troubles can damage the company's relationships with important constituencies.ⁿ³ Employees may become demoralized by concerns about job security and career advancement. Customers may be worried about the company's continued reliability as a source of supply or services. Trade creditors will likely be concerned about the company's ability to provide payment for goods and services delivered. These fears may cause members of these groups to take action that will have a negative effect on the company's operations and profitability. The company's most valuable employees may depart for other employers with a less uncertain future. Customers may switch their business to competitors. Trade creditors may refuse to ship except on the most stringent credit terms.

In most cases, if the company responds to these pressures quickly and effectively, the damage can be confined to an acceptable level. In some cases, however, this may not be possible. While recent experience suggests that most types of businesses can, if properly managed, withstand the effects of the negative publicity generated by a restructuring, there are certain businesses or types of businesses that are so dependent upon the confidence of their constituencies that the slightest hint of instability is fatal. The financial services industry is the most notable example of this phenomenon. Companies that hold and invest the funds of others are so dependent upon the confidence of their customers in their financial strength that absent the intervention of regulators, news of their financial instability causes immediate and irreparable damage.

FOOTNOTES:

(n1)Footnote 1. See 11 U.S.C. §§ 330(a) and 503(b)(2).

(n2)Footnote 2. See P 2.07 *infra* for a discussion of the relative effects of an out-of-court restructuring and a bankruptcy reorganization on the finances of the troubled company.

(n3)Footnote 3. See P 2.06[2]-[4] *infra* for a discussion of the relative effects of an out-of-court restructuring and a bankruptcy reorganization on these constituencies.



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Once it is determined that the troubled company is a candidate for restructuring, counsel must decide how this is best accomplished. Generally, a troubled company may restructure in either of two ways. The company may seek to restructure under the protection and supervision of the bankruptcy court in a case under chapter 11 of the Bankruptcy Code. Alternatively, the company may seek to restructure out-of-court in a privately negotiated transaction or "workout." A workout and a bankruptcy reorganization are alternate paths to the same end--a restructuring of the troubled company. These paths differ, however, in many significant respects. In order to select the path best suited to a specific company's needs, counsel must be familiar with these differences and must carefully analyze their impact on the company and its restructuring.



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P 2.05 Differences Between a Workout and a Bankruptcy Related to the Nature of the Restructuring Process.

Most differences between a workout and a bankruptcy reorganization derive ultimately from the fact that they are two fundamentally different processes. Although a great many issues may arise during an out-of-court restructuring, a workout is almost by definition more narrowly focused. Generally, only the company's lenders and other major creditors participate. The vast majority of the company's obligations are left unimpaired. In chapter 11, in contrast, the Bankruptcy Code allows for a comprehensive restructuring of all obligations of the debtor. All of the many constituencies of the company are brought to the negotiating table.

[1] Tools of the Restructuring Process.

The narrow focus of a workout is a product of the limited powers of the company in an out-of-court restructuring. In a workout, the company must ultimately rely on its powers of persuasion. It lacks the authority to resolve disputes unilaterally, to impose a restructuring on dissenters or to block creditors seeking to exercise their remedies. The Bankruptcy Code, on the other hand, provides the debtor seeking to reorganize with several tools designed to facilitate the formulation and implementation of a comprehensive restructuring.

[a] Dispute Resolution.

A workout is at its core a privately negotiated transaction. In some cases, state and federal regulatory agencies may play a role. For instance, when the troubled company seeks to restructure public debt or equity securities, the staff of the Securities and Exchange Commission will review the registration statement or proxy materials prepared in connection with the offer to, or solicitation of, the public security holders. However, in a workout there is no governmental or other body with the power to resolve disputes and bind participants. If the resolution of a dispute cannot be achieved consensually, the matter must be left unresolved. If the troubled company's financial condition or the terms of the restructuring will not permit this, the workout will fail.

In a case under the Bankruptcy Code, in contrast, the restructuring takes place under the supervision of the bankruptcy court. Federal procedural law empowers the bankruptcy court to hear and resolve disputes relating to the administration of the debtor's estate, including those relating to the allowance and disallowance of claims.ⁿ¹ Under section 502(b), the bankruptcy court is specifically charged with determining the amount of any claim as to which an objection has been filed.ⁿ² Further, under section 502(c) the bankruptcy court is authorized to "estimate" any contingent or unliquidated claim, the fixing or liquidation of which would unduly delay the administration of the bankruptcy case.ⁿ³ As a result, a

bankruptcy reorganization offers a debtor the opportunity to resolve problems that cannot be settled through negotiation.

[b] Binding Dissenting Creditors.

In a workout, the troubled company's ability to alter the terms of its obligations to creditors is governed, in the first instance, by the troubled company's contractual arrangements with those creditors. Under most loan agreements and other financing documents, the vast majority of terms and provisions can be amended, modified or waived with the consent of a majority or supermajority in principal amount of the debt held by the lenders party to the agreement. However, almost invariably, those provisions the relaxation of which is most essential to the troubled company--provisions relating to outstanding principal amount, rate of interest, amortization and final maturity, for instance--cannot be amended, modified or waived without the consent of each lender.ⁿ⁴ As a result of these restrictions, a troubled company seeking to relax its payment obligations is required to obtain the consent of each affected lender.ⁿ⁵

In the case of most private debt agreements, the need for unanimous consent does not pose a significant problem. Typically, the lenders party to the agreement are few in number. Moreover, when the assent of a majority in principal amount of the debt held by the lenders has been obtained, dissenters will frequently fall into line. Banks and insurance companies are reluctant to hold up a transaction for fear of being subject to similar treatment in another restructuring. In the case of public debt securities, however, the inability of a majority or a supermajority to bind dissenters is more problematic. First, these securities are often widely held. The assent of hundreds or even thousands of individual holders may be necessary. Second, public debt securities are frequently held by entities far less reluctant to resist the will of the majority. In fact, in some transactions, an investor will purchase a sizable piece of an issue for the very purpose of seeking to hold up the transaction and thereby extort better terms.ⁿ⁶

"Exchange offers" were developed as a response to these problems. In an exchange offer, the issuer of public debt securities offers its existing security holders some combination of new debt securities, equity securities and cash in exchange for their existing debt securities. By permitting each existing security holder to make an independent determination concerning the merits of the restructuring, the exchange offer reduces the leverage of individual holders. However, the economics of the restructuring usually require that an exchange offer be conditioned on acceptance by a very high percentage of the existing holders, often as high as 90% or 95%. In many cases, the need for such a high rate of acceptance makes an exchange offer impractical.ⁿ⁷ When an issue is widely dispersed, it may be impossible even to locate such a high percentage of the holders.

In a chapter 11 reorganization, the approval requirements are significantly less demanding. Under the Bankruptcy Code, a plan of reorganization may impair any class of claims or interests.ⁿ⁸ The only restriction on the manner in which a class of claims or interests may be impaired is the requirement that the plan provide for the same treatment for each claim or interest of a particular class.ⁿ⁹ The holders of claims and interests impaired by a plan may accept or reject the plan. However, a class of claims is considered to have accepted a plan if the plan has been approved by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims in the class counting for these purposes only those creditors actually voting.ⁿ¹⁰ Similarly, a class of interests is considered to have accepted a plan if the plan has been approved by holders of interests that hold at least two-thirds in amount of the allowed interests of such class voting on the plan.ⁿ¹¹ Once confirmed, the plan of reorganization binds all creditors and equity security holders of the debtor whether or not they approved the plan.ⁿ¹² As a result, in a bankruptcy reorganization, a restructuring may be imposed on a substantial minority of creditors and equity security holders.

[c] Automatic Stay.

In a workout, the troubled company is ultimately at the mercy of its creditors. Once the company has defaulted on its obligations, creditors are generally free to exercise any remedy available to them under their contractual arrangements with the company or at law. Unsecured creditors may seek a judgment against the company and, once a judgment has been obtained, sue for enforcement of the judgment. Secured creditors may foreclose upon and liquidate the property of

the company serving as collateral for their obligations. Many of these remedies require significant periods of time to effect, and the company may be able to raise defenses. In the end, however, a company in default on its obligations must have the patience and cooperation of its creditors or seek the protection of the bankruptcy court.

In contrast, in a case under the Bankruptcy Code, the debtor is protected by the shield of the automatic stay. *Section 362 of the Bankruptcy Code* stays, immediately and automatically, most acts against the debtor and its property.ⁿ¹³ It prohibits, for instance, the enforcement against the debtor or its property of a judgment obtained before the commencement of the case, any act to obtain possession of the debtor's property and any act to create, perfect or enforce a lien against the debtor's property. As a result, the commencement of a bankruptcy case offers the debtor respite from the prosecution of the law suits and other remedies that might have harassed it prepetition.ⁿ¹⁴

[2] Complexity of the Restructuring Process.

The enhanced powers of the debtor in a chapter 11 reorganization are both a benefit and a burden. As already discussed, the special tools made available to the debtor by the Bankruptcy Code facilitate the formulation and implementation of a comprehensive restructuring. However, with this broadened scope comes greater complexity. Many of the burdens with which a troubled company must contend in any restructuring are magnified in a bankruptcy reorganization.ⁿ¹⁵

[a] Number of Participants.

Most restructurings are complex, multi-lateral transactions. At a minimum, a workout will usually involve all of the troubled company's institutional lenders. In addition, other substantial creditors, such as a party to a major lease or contract, may be drawn into the negotiations. Finally, when the troubled company has issued public debt or equity securities, the troubled company may solicit the participation of the holders of the securities through an exchange offer or similar transaction. This may involve hundreds or even thousands of small security holders in the restructuring process.

Nonetheless, a reorganization under chapter 11 of the Bankruptcy Code often involves a substantially greater number of participants. This reorganization encompasses all of the debtor's obligations. Under the Bankruptcy Code, a plan of reorganization is binding on any creditor or equity security holder of the debtor.ⁿ¹⁶ In view of the broad scope of a chapter 11 reorganization, the procedural provisions of the Bankruptcy Code permit participation by all the debtor's many constituents in the reorganization process. *Section 1109 of the Bankruptcy Code* provides that any "party in interest" may raise and may appear and be heard on any issue in a case under chapter 11.ⁿ¹⁷ A "party in interest" is defined to include any creditor or equity security holder of the debtor, whether or not the debtor is in default on, or seeks to impair, its obligations to the creditor or equity security holder.ⁿ¹⁸

[b] Length of the Restructuring Process.

Any restructuring (whether out-of-court or in bankruptcy) will require a substantial period of time to complete. The reorganization of a large, complex corporation may demand significantly in excess of a year. On average, however, a troubled company will require a significantly longer period of time to restructure in a bankruptcy case. This phenomenon is the result of the greater procedural complexity of a bankruptcy reorganization.

In a workout, the troubled company is subject to few procedural requirements. If the consent of the institutional lenders is required, the troubled company must proceed consistently with the terms of the debt agreements governing its obligations to these creditors. However, these agreements rarely impose procedural requirements other than that any amendment, waiver or modification of the agreement be in writing. If the company requires action by its public security holders, the more cumbersome provisions of the federal securities laws may be implicated. But because the covenants contained in trust indentures are generally few in number and lenient in their terms, the troubled company will usually need to solicit the views of public security holders only in the event that it wishes to amend the basic economic terms of

their obligations.

The Bankruptcy Code and the Federal Rules of Bankruptcy Procedure, on the other hand, impose procedural requirements that are far more intrusive. These procedural requirements inhibit the debtor's operations during the course of the bankruptcy case. In addition, they serve to delay the formulation and implementation of the plan of reorganization through which the debtor will eventually exit the bankruptcy case.

Although the Bankruptcy Code authorizes the debtor to operate its business in the ordinary course,ⁿ¹⁹ it provides that most business actions that are not in the ordinary course may be taken by a debtor only after "notice and a hearing."ⁿ²⁰ *Section 102(1) of the Bankruptcy Code* provides that "after notice and a hearing" means such notice and such opportunity for a hearing as is appropriate in the particular circumstances.ⁿ²¹ Clarification as to what notice is appropriate in any particular circumstances is found in *Federal Rule of Bankruptcy Procedure 2002* and other provisions of the Federal Rules of Bankruptcy Procedure. Frequently, the provisions of the Federal Rules of Bankruptcy Procedure are demanding both as to who must be noticed and as to how much notice must be provided.ⁿ²²

The mechanics of preparing and filing a plan of reorganization are similarly burdensome. Under *section 1121(b) of the Bankruptcy Code*, a debtor has the exclusive right to file a plan of reorganization for 120 days after the bankruptcy court enters the order for relief.ⁿ²³ The court may reduce or increase the 120-day period for cause after notice and a hearing; however, a court may not extend the original 120-day period for filing a plan of reorganization beyond a date that is 18 months after the order for relief is entered.ⁿ²⁴

After successfully submitting a plan of reorganization, the debtor must then focus its efforts on plan confirmation. First, the debtor has up to 180 days after the order for relief is entered to obtain acceptances to its proposed plan of reorganization from each class of impaired claims.ⁿ²⁵ The court may reduce or increase the 180-day period for cause after notice and a hearing; however, the 180-day period for obtaining acceptances may not be extended beyond a date that is 20 months after the order for relief is entered.ⁿ²⁶ Additionally, the Bankruptcy Code requires significant and time-consuming disclosure in connection with voting on a plan of reorganization. Acceptances of a plan of reorganization may only be solicited after distribution of the plan (or a summary thereof) and a written disclosure statement.ⁿ²⁷ The disclosure statement must contain "adequate information" or information of a kind, and in sufficient detail, to enable a hypothetical reasonable investor typical of holders of claims or interests of the relevant class to make an informed judgment about the plan. In practice, this necessitates production and distribution in all bankruptcy reorganizations of a document akin to a registration statement required in connection with a public offering. In addition, the Bankruptcy Code requires time-consuming approval procedures in connection with plan confirmation. Unless the debtor solicited acceptances of the plan of reorganization before the commencement of the bankruptcy case under *section 1125(b) of the Bankruptcy Code*, a disclosure statement may only be distributed to creditors and interest holders after it is approved by the court.ⁿ²⁸ Such approval may only be granted after a hearing held on at least 25 days notice to all creditors and equity security holders.ⁿ²⁹ In the event the requisite acceptances are obtained, the plan of reorganization may only be confirmed after a hearing held on not less than 25 days notice to all creditors and equity security holders.ⁿ³⁰

[c] Disclosure and Publicity.

In both a workout and a bankruptcy reorganization, the troubled company will be obliged to disclose substantial quantities of information concerning its business, financial condition and efforts to restructure. Moreover, the dissemination of this information will often generate significant negative publicity. However, in a reorganization under chapter 11 of the Bankruptcy Code the disclosure requirements imposed on the debtor are greater and the resulting negative publicity is generally more severe.

In a workout, the troubled company's contractual agreements with its lenders and other major creditors will often require the disclosure of significant financial information. Generally, the company will be required to provide these

creditors with quarterly and annual financial statements, information relating to compliance with covenant obligations and other information the creditors may reasonably request. In some cases, these requirements will be supplemented by disclosure obligations arising in connection with the company's solicitation of its public debt or equity security holders. The company may be required to prepare and distribute a registration statement or other offering document in connection with a consent solicitation, exchange offer or similar transaction. Finally, disclosure may be compelled by the practical realities of the company's predicament. During the course of the workout, the company will frequently need the cooperation of its creditors. Inevitably, the creditors will demand information to assist them in evaluating the company's proposal. If the company truly needs the assistance of the creditors, it will have little choice but to provide the requested information.

Notwithstanding the burdensome disclosure obligations faced by the troubled company in a workout, these demands are generally more frequent and more extensive in scope in a bankruptcy reorganization. In connection with its very first step in bankruptcy, the filing of a petition for relief, the debtor must provide voluminous information concerning its business and financial condition. A bankruptcy petition must be accompanied (or followed shortly) by a list of the debtor's creditors and equity security holders, schedules of the debtor's assets and liabilities, a schedule of the debtor's current income and expenditures, a schedule of the debtor's executory contracts and unexpired leases and a statement concerning the debtors' financial affairs.ⁿ³¹ In many jurisdictions, the Operating Guidelines and Financial Reporting Requirements promulgated by the United States trustee require that this information be updated and supplemented periodically during the case.ⁿ³²

In addition, the Bankruptcy Code provides creditors, equity security holders and other parties in interest with a number of opportunities to conduct their own factual investigations.ⁿ³³ Pursuant to *section 341 of the Bankruptcy Code*, the United States trustee is charged with convening a meeting of the debtor's creditors which, pursuant to *Federal Rule of Bankruptcy Procedure 2003*, is to be held within 20-40 days after the order for relief.ⁿ³⁴ The debtor, in the person of one or more senior officers, is obliged to attend this meeting and submit to an examination under oath by the United States trustee and those creditors wishing to be heard.ⁿ³⁵ Any party in interest may seek additional opportunities to examine the debtor concerning its conduct, property or financial condition by making application to the bankruptcy court.ⁿ³⁶

Finally, as previously discussed,ⁿ³⁷ the Bankruptcy Code requires extensive disclosure in connection with the solicitation of acceptances of a plan of reorganization. *Section 1125 of the Bankruptcy Code* provides that an acceptance or rejection of a plan may not be solicited from a holder of a claim or interest unless there is transmitted to the holder "a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information."ⁿ³⁸ The requirement of a disclosure containing "adequate information" necessitates public disclosure of the magnitude required by the federal securities laws in connection with a public offering.

FOOTNOTES:

(n1)Footnote 1. 28 U.S.C. § 157(b).

(n2)Footnote 2. 11 U.S.C. § 502(b). See generally P 1.07[4] *supra*.

(n3)Footnote 3. 11 U.S.C. § 502(c)(1).

(n4)Footnote 4. In the case of public debt securities issued pursuant to trust indentures qualified under the Trust Indenture Act of 1939, these strict limitations on a borrower's ability to alter its contractual obligations are statutorily mandated. For instance, section 316(b) of the Trust Indenture Act provides that all indentures qualified under the Act must contain a provision prohibiting any impairment of a holder's right to receive each installment of principal and interest on the scheduled payment date without the holder's consent. 15 U.S.C. § 77ppp(b); see also P 5.09 *infra*.

(n5)Footnote 5. Generally, a troubled company has greater ability to modify its obligations to its equity security holders. Under the corporate law of most jurisdictions, changes to the terms of equity securities can be made with the

approval of a prescribed majority of holders. *See Del. Code Ann. tit. 8 § 242(b); N.Y. Bus. Corp. L. § 803. But see PP 5.05[1], 5.07, 5.11 and 5.12 infra* for a discussion of the limitations on the solicitation of consents from shareholders imposed by the federal securities laws.

(n6)Footnote 6. This type of investor also purchases bank and insurance company debt in the secondary market, importing some of these same problems into the restructuring of private debt.

(n7)Footnote 7. *See* ch. 5 *infra* for a discussion of the various means by which public debt securities may be restructured in a workout and the problems inherent in each.

(n8)Footnote 8. 11 U.S.C. § 1123(b)(1).

(n9)Footnote 9. 11 U.S.C. § 1123(a)(4) (stating that a plan shall "provide the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to a less favorable treatment of such particular claim or interest").

See P 1.09[1][b] supra for a discussion of the elements of a plan of reorganization.

(n10)Footnote 10. 11 U.S.C. § 1126(c).

(n11)Footnote 11. 11 U.S.C. § 1126(d).

(n12)Footnote 12. In fact, through the mechanism of "cramdown," the Bankruptcy Code permits the imposition of a plan of reorganization on an entire class of claims or interests that has voted against the plan. This may be accomplished if the plan provides for a distribution to the dissenting class of property of a value, as of the effective date of the plan, equal to the allowed amount of the claims in the class or the plan provides that the holders of claims and interests junior to the claims or interests in the dissenting class will not receive any distribution. 11 U.S.C. § 1129(b). *See PP 1.09[3][c] supra* and 7.04[4][d][ii] *infra* for more comprehensive discussions of cramdown.

(n13)Footnote 13. 11 U.S.C. § 362. The scope of the stay is sometimes extended to protect non-debtors pursuant to the bankruptcy court's equitable powers under section 105(a). *See, e.g., In re Dow Corning Corp.*, 86 F.3d 482, 493-94, 36 C.B.C.2d 218 (6th Cir. 1996) ; *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1002-03, 15 C.B.C.2d 235, 245-47 (4th Cir. 1986) , *cert. denied*, 479 U.S. 876, 107 S. Ct. 251, 93 L. Ed. 2d 177 (1986) ; *In re Midway Airlines Corp.*, 283 B.R. 846, 851-52 (E.D.N.C. 2002) ; *In re Nat'l Century Fin. Enter., Inc.*, 423 F.3d 567, 574 (6th Cir. 2005) ; *Kreiser v Goldberg*, 478 F.3d 209, 215 (4th Cir. 2007) .

(n14)Footnote 14. *See P 1.05 supra* for a more detailed discussion of the automatic stay.

(n15)Footnote 15. A prepackaged bankruptcy may offer many of the benefits of a bankruptcy reorganization without the enhanced burdens. *See generally P 6.02 et seq. infra*.

(n16)Footnote 16. 11 U.S.C. § 1141(a). The broad scope of a bankruptcy reorganization is further evidenced by the manner in which the Bankruptcy Code defines the term "creditor." Under section 101, a "creditor" is described as an entity that has a "claim" against the debtor. 11 U.S.C. § 101(10). Section 101 defines claim to include a "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." 11 U.S.C. § 101(5)(A).

(n17)Footnote 17. 11 U.S.C. § 1109(b).

(n18)Footnote 18. *Id.*

(n19)Footnote 19. 11 U.S.C. § 1108.

(n20)Footnote 20. *Section 363 of the Bankruptcy Code*, for instance, provides that the debtor may use, sell or lease property of the estate other than in the ordinary course of business only after notice and a hearing. *11 U.S.C. § 363(b)(1)*. Similarly, a bankruptcy court may authorize the debtor to obtain unsecured credit other than in the ordinary course of business only after notice and a hearing. *11 U.S.C. § 364(b)*; *see also 11 U.S.C. § 365* (assumption and rejection of executory contracts and unexpired leases); § 554 (abandonment of property of the estate). *See generally P 1.06 supra*.

(n21)Footnote 21. *11 U.S.C. § 102(1)(A)*. The section goes on to provide that an actual hearing is not required if notice is properly given and a hearing is not requested timely by a party in interest. *11 U.S.C. § 102(1)(B)*.

(n22)Footnote 22. For example, *Fed. R. Bankr. P. 2002(a)(2)* requires no less than 20 days notice to all creditors for any proposed use, sale or lease of property of the estate other than in the ordinary course of business, while subdivision (a)(6) requires at least 20 days notice only if a particular entity is requesting more than \$1,000 as compensation or reimbursement of expenses. At least 15 days notice to any official committee and such other entities as the bankruptcy court may direct is required for any incurrence of credit under section 364. *Fed. R. Bankr. P. 4001(c)*. The bankruptcy court may, however, for cause shown, permit the debtor to provide more limited notice. In large, complex cases, the court often employs this power to limit notice of all but the most significant transactions to the United States trustee, representatives of the official committees and parties directly affected.

(n23)Footnote 23. *11 U.S.C. § 1121(b)*.

(n24)Footnote 24. *11 U.S.C. § 1121(d)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised) ("2005 Act"). Prior to the 2005 Act, the Bankruptcy Code did not impose any limits on the number or length of an extension, and in practice, courts were extremely lenient in extending the exclusivity period. Given that the ability to determine if and when a plan of reorganization will be filed is an important source of leverage for debtors in negotiations with creditors, it remains to be seen whether creative debtors and bankruptcy courts will find a way around the new 18-month deadline. For example, the 2005 Act does not compel a bankruptcy court to schedule hearings on a plan filed by a creditor. Nonetheless, this new exclusivity provision will likely have a serious impact on plan negotiations between the debtor and creditor constituencies in many cases. Different time periods and extension standards are applicable in small business cases. *See 11 U.S.C. 1121(e)*, as amended in 2005.

(n25)Footnote 25. *11 U.S.C. § 1121(c)*.

(n26)Footnote 26. *11 U.S.C. § 1121(d)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n27)Footnote 27. *See 11 U.S.C. § 1125(b)*. However, in small business cases, the bankruptcy court may conditionally approve a disclosure statement, subject to final approval after notice and a hearing, and acceptances and rejections of the plan may be solicited based on the conditionally approved disclosure statement if it provides "adequate information." *See 11 U.S.C. § 1125(f)*, as amended in 2005. *See also Fed. R. Bankr. P. 3017.1* and *Interim Rule 3017.1*. In cases filed before October 17, 2005, a conditionally approved disclosure statement could be used for solicitation purposes only if the debtor elected to be treated as a small business. *See also 11 U.S.C. § 1125(f)(1)*, added in 2005, which provides that, in a small business case, the court may determine that the plan itself provides adequate information and that a separate disclosure statement is not necessary.

(n28)Footnote 28. *See 11 U.S.C. § 1125(b)*. As noted at n.27 *supra*, in the case of a small business debtor, a conditionally approved disclosure statement may be distributed. The conditionally approved disclosure statement must be mailed not later than 25 days before the date of the hearing on plan confirmation and the hearing on the disclosure statement may be combined with the hearing on plan confirmation. *See 11 U.S.C. § 1125(f)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n29)Footnote 29. *Fed. R. Bankr. P. 2002(b), (d)(5)*.

(n30)Footnote 30. *Id.* See *P 1.09 supra* for a more detailed discussion of the mechanics of plan confirmation.

(n31)Footnote 31. See *11 U.S.C. § 521(a); Fed. R. Bankr. P. 1007; Interim Rule 1007*. See *P 9.07 infra* for a more extensive discussion of the debtor's disclosure obligations in connection with the filing of a petition for relief.

(n32)Footnote 32. The Operating Guidelines and Financial Reporting Requirements promulgated by the Office of the United States Trustee for the Districts of New York, Connecticut, and Vermont, *available at* <http://www.usdoj.gov/ust/r02/manhattan/chapter11.htm>, for instance, require the filing of monthly financial statements, including a profit and loss statement and balance sheet prepared in accordance with generally accepted accounting principles, and schedules of cash receipts and disbursements, accounts payable, accounts receivable, federal, state and local taxes, collected, received, due or withheld and costs of goods sold. The Operating Guidelines for Chapter 11 Cases promulgated by the Office of the United States Trustee for the Districts of New Jersey, Delaware and Pennsylvania provide forms for monthly operating reports giving similar information about the debtor, in addition to monthly summaries of unpaid postpetition debts and monthly bank reconciliations for each bank account the debtor holds.

These requirements are enacted pursuant to *28 U.S.C. § 586*, which charges the United States trustee with supervising the administration of cases under chapter 11. *28 U.S.C. § 586(a)(3)*.

(n33)Footnote 33. The Bankruptcy Code, in fact, empowers the official committee of unsecured creditors and any other official committees appointed in a case to investigate the affairs of the debtor. Section 1103(c)(2) provides that a committee may "investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan." *11 U.S.C. § 1103(c)(2)*.

(n34)Footnote 34. *11 U.S.C. § 341(a); Fed. R. Bankr. P. 2003; Interim Rule 2003*. The United States trustee may also, at its discretion, convene a meeting of the debtor's equity security holders. *11 U.S.C. § 341(b)*.

(n35)Footnote 35. See *11 U.S.C. § 343; Fed. R. Bankr. P. 2003; Interim Rule 2003*.

(n36)Footnote 36. See *Fed. R. Bankr. P. 2004*.

(n37)Footnote 37. See *P 2.05[2][b] supra*.

(n38)Footnote 38. *11 U.S.C. § 1125(b)*.



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Collier Business Workout Guide

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CHAPTER 2 Initiating the Workout

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P 2.06 Operation of the Troubled Company During the Restructuring.

A workout and a bankruptcy reorganization may affect the operations of the troubled company in substantially different ways.

[1] Management of the Troubled Company.

The rules of corporate governance are unaffected by the commencement of a workout. The allocation of rights and responsibilities among the troubled company's shareholders, directors and officers continues to be governed by the company's certificate of incorporation and bylaws and the law of the company's state of incorporation. Under these governing rules, the day-to-day operations of the company continue to be managed by its board of directors and officers. In a workout, however, the dynamics of corporate governance are influenced by two new forces, one legal and one practical.

First, the scope of the fiduciary duties of the troubled company's board of directors is broadened. The directors of a financially healthy corporation owe fiduciary duties of care and loyalty to the corporation's shareholders. When a corporation becomes insolvent, the body of claimants to whom these duties are owed is expanded to include the corporation's creditors.ⁿ¹ Typically, the extension of the directors' obligations to this new constituency does not have a dramatic impact on the management of the company. The directors of most corporations have been conditioned by years of experience to focus instinctively on the interests of the corporation's shareholders. As a consequence, in most workouts, management consciously or unconsciously casts itself in the role of representative of the existing shareholders and seeks to maximize their interest in the restructured company.

Nonetheless, in confronting those issues pivotal to the success of the restructuring, including the question of whether to restructure out-of-court or in a bankruptcy case, the directors of the company must be cognizant of their obligations to the creditors. While the directors of a troubled company may, and often will, seek to defend the interests of the company's shareholders in the workout negotiations, there are limits beyond which the directors should not go in pursuing these ends. For instance, they should not take extraordinary operational risks in an effort to generate value for the company's shareholders. Similarly, they should not place the company's ability to restructure in mortal danger in an effort to extort a more generous allocation from the company's creditors.ⁿ²

The troubled company's financial distress gives rise to a second, and often more important, force affecting the

company's management. Faced with the specter of financial loss, the company's shareholders and creditors often will seek to limit management's freedom of activity. Existing contractual and statutory limitations will be enforced strictly. If the company requires concessions in order to survive, its lenders will seek to further limit its ability to engage in activities not in the ordinary course of business as consideration for these concessions. In cases in which the troubled company's constituents are particularly concerned about the operating expertise of its management, they may press the company to retain a "crisis manager" or similar specialist as a further check on the company's freedom of activity.ⁿ³

Typically, in a bankruptcy reorganization, the debtor's business and the conduct of the case are managed by the debtor itself, as debtor in possession.ⁿ⁴ Moreover, except in extraordinary circumstances, the usual rules of corporate governance prevail. The directors and officers of the debtor continue to manage the debtor's affairs subject to the right of the debtors stockholders to replace directors and vote on certain material transactions.ⁿ⁵ In bankruptcy, however, the limitations on the debtor's management that were imposed informally in the workout are formalized and, in some cases, expanded.

Given the increased stress and more limited financial rewards associated with working for a company in financial distress, troubled companies often find it difficult to retain experienced managers. As a result, debtors frequently seek to institute key employee retention programs, or KERPs, shortly after the commencement of a bankruptcy case. Before a debtor can institute a KERP for the benefit of an insider (usually an officer or director of the troubled company), the bankruptcy court must find that several tests are satisfied. First, the payment or obligation must be essential to the retention of such person because the individual has a bona fide job offer from another business at the same or greater rate of compensation.ⁿ⁶ Second, the services provided by the individual must be "essential to the survival of the business."ⁿ⁷ Third, the amount of the payment or obligation must not exceed 10 times the mean of similar payments made to non-management employees for any purpose during the calendar year.ⁿ⁸ In addition to limiting the availability of KERPs, *section 503(c) of the Bankruptcy Code* also prohibits any severance payment to an insider unless the payment is part of a program generally applicable to all full-time employees and the amount of the payment is not greater than ten times the amount of the mean severance given to non-management employees during the calendar year.ⁿ⁹ Finally, the Bankruptcy Code prohibits other transfers or obligations that are outside of the ordinary course of business and not justified by the facts and circumstances of the case.ⁿ¹⁰ This last prohibition is not limited to insiders.ⁿ¹¹

Additionally, in a chapter 11 case, the debtor's fiduciary obligations to its creditors are given concrete form in the provisions of the Bankruptcy Code concerning activities not in the ordinary course of business. The debtor may only engage in material transactions, such as the use, sale or lease of property and the incurrence of credit, after obtaining the approval of the bankruptcy court. This approval is only forthcoming if the debtor can demonstrate a "sound business purpose" for the transaction,ⁿ¹² or, alternatively, where the transaction passes a permissive "business judgment test."ⁿ¹³

Similarly, the Bankruptcy Code provides for the creation of an official vehicle through which the debtor's creditors may bring their influence to bear. The Bankruptcy Code mandates the creation of at least one official committee representing creditors holding unsecured claimsⁿ¹⁴ and empowered to perform such services "as are in the interest of those represented," including consultation with the debtor concerning administration of the case and participation in the formulation of a plan of reorganization.ⁿ¹⁵ The influence of creditors in a bankruptcy reorganization case is reinforced by the provisions of the Bankruptcy Code concerning notice and a hearing. The Bankruptcy Code requires that in connection with seeking the approval of the bankruptcy court for significant actions, the debtor provide appropriate notice and an opportunity for a hearing.ⁿ¹⁶ The Bankruptcy Code further provides that any party in interest, including any creditor, may appear and be heard on any issue in the case.ⁿ¹⁷

Finally, the Bankruptcy Code provides creditors with a means for affecting the management of the debtor not available in a workout. Under *section 1104(a) of the Bankruptcy Code*, the bankruptcy court, on request of any party in interest or the United States trustee, may order the appointment of a trustee "for cause," "if such appointment is in the interests of

creditors, any equity security holders, and other interests of the estate," or "if grounds exist to convert or dismiss the case under section 1112"n18 of the Bankruptcy Code, "but the court determines that the appointment of a trustee or an examiner is in the best interests of creditors and the estate."n19 The requirement of "cause" necessitates a showing of malfeasance, such as fraud or dishonesty, or gross mismanagement. The "interests of creditors" standard is more flexible and focuses on the debtor's ability to progress towards a successful plan of reorganization.n20 Upon appointment, the trustee assumes control of the debtor's operations and management of the bankruptcy case, replacing the debtor's existing management.n21

[2] Impact of the Restructuring on the Troubled Company's Employees.

Most restructurings (whether out-of-court or in bankruptcy) affect employee productivity negatively. At senior management levels, the burdens of the restructuring distract the troubled company's officers from operational issues. At all levels, the company's financial distress and uncertain future demoralize the workforce. Inevitably, employees are concerned about career advancement and job security. In addition, in cases in which the employees have a financial stake in the company's future--through a employee stock ownership plan or underfunded employee benefit plans, for instance--news of the company's distress may have an even greater impact.

In a workout, the troubled company is often able to soften the impact of the restructuring process on its employees. The company may be forced to significantly reduce the size of its workforce. However, it is generally able to shield its continuing employees from the short-term effects of its financial distress. In most cases, the company will continue to pay wages and other compensation obligations during the workout. In some cases, it may even have the ability to provide incentive packages to key employees to discourage them from departing.

In a chapter 11 reorganization, by contrast, the debtor's ability to shield its continuing employees is more limited. Under the Bankruptcy Code, the filing of a petition for relief freezes all claims arising before the commencement of the bankruptcy case.n22 This rule encompasses virtually all of the debtor's obligations to its employees.n23 For example, after the commencement of the case, the debtor may not pay wages or other compensation accrued and unpaid on the day of the bankruptcy filing, obligations under indemnification agreements entered into prior to the filing daten24 or amounts owing to pension and other employee benefit plans on the date of the filing.n25 Some of these obligations, including claims for wages, salaries and commissions, are accorded a priority under the Bankruptcy Code over most other claims arising prior to the commencement of the case.n26 However, the amount of the priority is limited to \$10,950 and payment is not made until the conclusion of the bankruptcy case.n27

[3] Impact of the Restructuring on the Troubled Company's Customers.

The initiation of a restructuring will also affect the troubled company's relationship with its customers. News of the company's financial distress may cause customers concern about the company's reliability. They may worry about the continued availability of goods and services. They may fear that the company's distress will distract management and employees from operations and result in a reduction in the quality of the company's goods and services. In extreme cases, they may fear that the company will not survive the restructuring and that consequently there will be no one to make good on long-term obligations, such as warranties and service contracts.

These concerns may cause customers to act in undesirable ways. Customers may increase their demands on the company. Fearful of being left without recourse, customers may accelerate their return of goods or demands for services. In addition, some customers may seek to take advantage of the company's predicament. They may withhold or delay payments, assuming that the company is too distracted by the demands of its restructuring to take effective action. Finally, customers may simply take their business elsewhere.

The conventional wisdom is that while a troubled company will confront these problems in both a workout and a bankruptcy reorganization, the commencement of a bankruptcy case will likely exacerbate the company's troubles. The

extent of a company's difficulties with its customers is in large part a function of the level of publicity concerning its financial distress and the public perception regarding its prospects for a successful restructuring. The commencement of a case under the Bankruptcy Code aggravates both problems. As previously discussed,ⁿ²⁸ a bankruptcy reorganization generates a greater awareness of the debtor's financial troubles among its many constituencies. In addition, while the general public is far more sophisticated today than in the past concerning bankruptcy, the announcement of a bankruptcy filing still raises the specter of liquidation in many minds.

[4] Impact of the Restructuring on the Troubled Company's Suppliers.

In assessing the impact of the restructuring on the troubled company's suppliers, the adequacy of the company's cash flow is the determinative factor. If liquidity is not a constraint, a workout affords the company great flexibility in dealing with its suppliers. The company will usually have the freedom to determine if and when to pay its suppliers. In most cases, lenders will readily consent to (or acquiesce in) the continued payment of trade creditors, even while their interest and principal payments are being deferred. Lenders are well aware of the vulnerability of most businesses to any dramatic reduction in trade credit.

The filing of a bankruptcy petition, on the other hand, freezes all claims arising prior to the commencement of the case, including the claims of trade creditors. As a result, the debtor may not pay obligations owing to its trade creditors on the date of the commencement of the bankruptcy case without court approval. The court's power to grant such approval is itself a matter of significant disagreement.ⁿ²⁹ Moreover, the debtor's ability to prefer particular trade creditors is limited. In a bankruptcy reorganization, unlike a workout, the debtor cannot keep its most important suppliers current while stretching out payments to non-essential suppliers. Finally, the debtor is subject to a trade creditor's right of reclamation. Under *Section 546 of the Bankruptcy Code*, a seller who provides goods in the ordinary course of business to a debtor may reclaim such goods while the debtor is insolvent if the seller makes a written demand within 45 days of the debtor's receipt of the goods or within 20 days of such receipt if the original 45-day period expires after the commencement of the bankruptcy case.ⁿ³⁰ In addition, even if the seller fails to give written notice, the seller receives an administrative expense priority claim for the value of any goods received by the debtor in the ordinary course of the debtor's business within 20 days before the date of commencement of a case.ⁿ³¹

However, when the troubled company's cash flow does not permit current payments to at least the company's most important trade creditors, the flexibility offered by a workout may be illusory. When payment in full is not a possibility, the company may not be able to offer the supplier any alternative comfort. In many cases, the most obvious alternative, a lien securing further advances of credit by the supplier, is unavailable. Negative pledge provisions contained in the company's debt agreements will effectively prohibit the grant of any security interest.

In such cases, a bankruptcy filing may be the most attractive option. While the debtor will be prohibited from paying claims arising prior to the filing of the bankruptcy petition, it will at least have the ability to offer suppliers assurances concerning the collectability of claims arising after the filing date. Under *section 507(a)(2) of the Bankruptcy Code*, "the actual, necessary costs and expenses of preserving the estate, including wages, salaries, and commissions for services rendered after the commencement of the case" are accorded priority over all unsecured prepetition obligations, except for unsecured claims for domestic support obligations, of the debtor and over most other priority claims.ⁿ³² In addition, the Bankruptcy Code permits the debtor to incur such expenses in the ordinary course of business without the authorization of the bankruptcy court.ⁿ³³

[5] Impact of the Restructuring on the Troubled Company's Contractual Relationships.

In a workout, the troubled company's ability to modify its contractual relationships is limited. The company's right to amend or terminate a contract or unexpired lease is governed by the provisions of the contract or lease. In virtually all cases, the agreement will prohibit modification or termination without the consent of the other party. In addition, the agreement will often prohibit assignment of the company's rights and responsibilities without consent. As a result, as

with its other obligations, the troubled company may only alter its contractual relationships in a workout through negotiation.

In addition, in a workout, the troubled company may have difficulty keeping material contracts and leases in place. In the event of a material default by the company, the other party to the contract will be free to exercise any remedies available to it under the contract or at law. These remedies will generally include termination of the contract or lease and with it the company's right to enjoy the benefits of the arrangement in the future. Often, the other party will be eager to exercise its right to terminate because of fears that the troubled company will commence a case under the Bankruptcy Code and thereby deprive it of the right to do so at a later date. This rush to termination can usually be managed. However, in doing so the company will have to rely on its powers of persuasion rather than on any statutory authority.

A chapter 11 reorganization affords a debtor far more flexibility in dealing with its contractual and lease arrangements. Even in a chapter 11 case the debtor may not modify the terms of a contract or lease without the consent of the other party. However, the debtor may adjust most of its contractual and lease arrangements in a variety of other ways on a nonconsensual basis.ⁿ³⁴ First, if the debtor is party to an executory contractⁿ³⁵ or unexpired lease that is burdensome to the estate, the debtor may "reject" the contract or lease and thereby terminate its obligation to continue to perform thereunder.ⁿ³⁶ The rejection is deemed to be a breach of the contract or lease as of the date immediately preceding the date of the filing of the debtor's bankruptcy petition, and the other party to the contract or lease is left with an unsecured prepetition claim for damages.ⁿ³⁷ To the extent the debtor is party to an executory contract or unexpired lease that is valuable, the debtor can "assume" the contract or lease and thereby compel the other party to continue to perform thereunder.ⁿ³⁸ The debtor is free to assume an executory contract or unexpired lease notwithstanding the existence of defaults thereunder so long as it promptly cures the defaults or provides adequate assurance of prompt cure.ⁿ³⁹ To the extent the default relates to a provision concerning the insolvency or financial condition of the debtor or the commencement of the chapter 11 case, the debtor need not cure the default.ⁿ⁴⁰ Finally, if the debtor is party to an executory contract or unexpired lease that is valuable but no longer of use to the debtor, the debtor may assign the contract or lease to a third party for consideration so long as the assignee provides adequate assurance of future performance.ⁿ⁴¹ The assignment of the contract or lease operates as a total release of the debtor from any and all post-assignment liability under the contract or lease.ⁿ⁴² The debtor may assign an executory contract or unexpired lease notwithstanding a provision in the contract or lease specifically prohibiting, restricting or conditioning assignment.ⁿ⁴³

FOOTNOTES:

(n1)Footnote 1. See PP 3.03 and 3.04 *infra* for a more comprehensive discussion of the fiduciary duties of the directors of a troubled company.

(n2)Footnote 2. See PP 3.03 and 3.04 *infra* for a more comprehensive discussion of the fiduciary duties of the directors of a troubled company.

(n3)Footnote 3. See P 4.05[2] and [3] *infra* for a discussion of the issues raised by undue interference or the exercise of excessive control by lenders.

(n4)Footnote 4. There is a strong presumption in favor of permitting the debtor in possession to continue to operate the business. See, e.g., *In re Marvel Entertainment Group, Inc.*, 140 F.3d 463, 471, 39 C.B.C.2d 1315 (3d Cir. 1998) ; *In re Ionosphere Clubs, Inc.*, 22 C.B.C.2d 1583, 1586, 113 B.R. 164, 167 (Bankr. S.D.N.Y. 1990) ; *In re G-I Holdings Inc.*, 295 B.R. 502, 510 (D. N.J. 2003) ; *In re Worldcom, Inc.*, 2003 Bankr. LEXIS 2192, *16 (Bankr. S.D.N.Y. March 16, 2003) . In such event, the debtor in possession has most of the rights and responsibilities of a trustee. See 11 U.S.C. §§ 1107(a) and 1108.

(n5)Footnote 5. See *Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.)*, 801 F.2d 60, 64, 15 C.B.C.2d 645, 649-50 (2d Cir. 1986) . However, the debtor's shareholders are not permitted to use their voting rights in a manner that may jeopardize the reorganization process. See P 3.04[6] *infra*.

(n6)Footnote 6. *11 U.S.C. § 503(c)(1)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. *Id.*

(n8)Footnote 8. *Id.* If no such payments were made to non-management employees during the calendar year, the amount cannot exceed 25 percent of the amount of any similar transfer or obligation made to, or incurred for the benefit of, the individual during the prior year. *11 U.S.C. § 503(c)(1)(C)*.

(n9)Footnote 9. *11 U.S.C. § 503(c)(2)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. *Section 548 of the Bankruptcy Code*, the Code's fraudulent conveyance provision, also provides that any payment to, or for the benefit of, an insider and any obligation incurred to, or for the benefit of, an insider under an employment contract is fraudulent if made or incurred in exchange for less than a reasonably equivalent value and not in the ordinary course of business. *11 U.S.C. § 548(a)(1)(B)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. In contrast to other types of fraudulent conveyances, no showing is required with respect to the debtor's solvency or financial condition in the case of payments under an employment contract. *See id.*

(n10)Footnote 10. *11 U.S.C. § 503(c)(3)*.

(n11)Footnote 11. *See id.* Although Congress intended for the new changes to prevent abuses of the system, the changes to section 503(c) may make it increasingly difficult for debtors to retain and attract valuable employees.

(n12)Footnote 12. *See, e.g., Stephens Indus., Inc. v. McClung*, 789 F.2d 386, 390, 14 C.B.C.2d 1298, 1303 (6th Cir. 1986) ; *In re Aerovox, Inc.*, 269 B.R. 74, 80-82 (Bankr. D. Mass 2001) (reciting "sound business judgment" standard); *In re Eagle Pitcher Holdings, Inc.*, 2005 Bankr. LEXIS 2894, *2 (Bankr. S.D.Ohio April 26, 2005) .

(n13)Footnote 13. *In re Global Crossing Ltd.*, 295 B.R. 726, 742-44, 50 C.B.C.2d 900 (Bankr. S.D.N.Y. 2003) ; *see also In re Lionel Corp.*, 722 F.2d 1063, 1070, 9 C.B.C.2d 941, 950-51 (2d Cir. 1983) .

(n14)Footnote 14. *11 U.S.C. § 1102(a)(1)*. However, section 1102(a)(3) provides that "[o]n request of a party in interest in a case in which the debtor is a small business debtor and for cause, the court may order that a committee of creditors not be appointed." *11 U.S.C. § 1102(a)(3)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

The Bankruptcy Code also provides that the bankruptcy court (on request of a party in interest) may order the United States trustee to appoint additional committees of creditors or of equity security holders. *11 U.S.C. § 1102(a)(2)*.

(n15)Footnote 15. *11 U.S.C. § 1103(c)*. To facilitate provision of these services, the Bankruptcy Code authorizes each official committee to employ attorneys, accountants and other agents. *11 U.S.C. § 1103(a)*.

(n16)Footnote 16. *See e.g., 11 U.S.C. §§ 363(b), 502(b), 503(b), and 1128(a)*. For the Bankruptcy Code's definition of "after notice and a hearing," *see 11 U.S.C. § 102(1)*.

(n17)Footnote 17. *11 U.S.C. § 1109(b)*.

(n18)Footnote 18. *Section 1112(b) of the Bankruptcy Code* provides that the court "shall," subject to limited exceptions described below, convert or dismiss a case on request of a party in interest if that party is able to establish "cause." Although the list is not exhaustive, section 1112 specifies 16 conditions that constitute cause, including substantial or continuing loss to or diminution of the estate and the absence of a reasonable likelihood of rehabilitation; gross mismanagement of the estate; and failure to maintain appropriate insurance that poses a risk to the estate or to the

public. Section 1112 also provides for several exceptions to mandatory conversion or dismissal. First, the debtor may avoid conversion or dismissal of its case by showing that (i) there is a reasonable likelihood that a plan will be confirmed within a reasonable period of time and (ii) the grounds for granting such relief 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 fixed by the court. Second, the court may deny a request for conversion or dismissal by specifically identifying circumstances that establish that the conversion or dismissal is not in the best interests of creditors and the estate. Finally, the court may determine that the appointment of a trustee or examiner, rather than conversion or dismissal of the case, is in the best interests of the estate.

(n19)Footnote 19. *11 U.S.C. § 1104(a)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. *See generally P 1.04[4] supra*.

(n20)Footnote 20. *See In re Ionosphere Clubs, Inc.*, 22 C.B.C.2d 1583, 1587, 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990) ; *In re Adelphia Communs. Corp.*, 336 B.R. 610, 658 (Bankr. S.D.N.Y. 2006) .

(n21)Footnote 21. *See 11 U.S.C. § 1106*. When the appointment of a trustee is not appropriate, the bankruptcy court may (and, if the debtor's fixed, liquidated unsecured debts exceed \$5 million, must) appoint an examiner. *See P 1.04[4] supra*.

(n22)Footnote 22. *See P 6.04[2] infra* for a discussion of the problems caused by this prohibition in a prepackaged bankruptcy and ways with which these problems may be dealt.

(n23)Footnote 23. The prohibition on payment of obligations arising before the commencement of the bankruptcy case does not apply to "retiree benefits." Under *section 1114(e) of the Bankruptcy Code*, the debtor must continue to pay retiree benefits unless the bankruptcy court permits a modification of the payments. *11 U.S.C. § 1114(e)*. The court may grant this permission only if the debtor makes a proposal for modification of the benefits to an authorized representative of the retirees, negotiates with the representative "in good faith," the representative refuses to accept the proposal "without good cause" and the modification is necessary to permit the reorganization of the debtor, treats all parties "fairly and equitably" and is clearly favored by the "balance of the equities." *11 U.S.C. § 1114(f) and (g)*. Additionally, for cases filed on or after October 17, 2005, the court must reinstate pre-existing retiree benefits if the debtor, while insolvent and within 180 days before the filing of a bankruptcy petition, modified retiree benefits, unless it finds that "the balance of the equities clearly favors such modification." *11 U.S.C. § 1114(l)*.

Section 1114 defines "retiree benefits" to include all "payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death." *11 U.S.C. § 1114(a)*.

(n24)Footnote 24. *See generally P 3.05[5][b] infra*.

(n25)Footnote 25. *See Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc.*, 789 F.2d 98, 103-04, 14 C.B.C.2d 1075, 1082-83 (2d Cir. 1986) .

(n26)Footnote 26. *11 U.S.C. § 507(a)(4)*. The Bankruptcy Code also accords priority to certain unsecured claims for contributions to an employee benefit plan. *11 U.S.C. § 507(a)(5)*.

(n27)Footnote 27. *11 U.S.C. § 507(a)(4)*. *Section 104 of the Bankruptcy Code*, as amended by Pub. L. No. 103-394, and Pub. L. No. 109-8 provides for the adjustment of dollar amounts in certain sections of the Bankruptcy Code every three years, beginning April, 1, 1998 in order to reflect inflation. Most recently, section 507(a)(4) was amended to increase the claim amount to \$10,950 for cases commenced on or after April 1, 2007. In cases filed before April 1, 2007, the old amount (\$10,000) still applies.

(n28)Footnote 28. *See P 2.05[2][c] supra*.

(n29)Footnote 29. The "necessity of payment" doctrine, developed by the Supreme Court in a series of decisions rendered at the turn of the century, holds that a debtor should be permitted to pay a creditor's prepetition claims when the creditor is the only available source of goods or services essential to the debtor's business and refuses to continue to supply these goods or services unless the claims are paid. *See Gregg v. Metropolitan Trust Co.*, 197 U.S. 183, 186-88, 25 S. Ct. 415, 416, 49 L. Ed. 717, 718 (1905) ; *Dudley v. Mealey*, 147 F.2d 268, 1945 U.S. App. LEXIS 4412 (2d Cir. N.Y. 1945) , *cert. denied*, 325 U.S. 873, 65 S. Ct. 1415, 89 L. Ed. 1991 (1945) . Since the enactment of the Bankruptcy Code, debtors have invoked the doctrine to varying degrees of success. In some jurisdictions, in large, complex cases, debtors often are granted special court authorization to satisfy a variety of prepetition obligations. Such authorization is frequently granted on or shortly after the petition date. In these jurisdictions, such "first day" orders have allowed the debtor, for example, to pay prepetition wage and benefit claims, honor prepetition customer obligations, pay prepetition claims of "critical" vendors and satisfy certain lienable claims, such as claims for *ad valorem* property taxes, PACA / PASA claims and mechanics' lien claims. *See e.g. In re Just for Feet, Inc.*, 242 B.R. 821 (D. Del. 1999) (critical vendors); *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 1989 Bankr. LEXIS 490 (Bankr. S.D.N.Y. 1989) (prepetition employee claims). Recently, however, courts in other jurisdictions, including at least one circuit court, have expressly disapproved of the use of the necessity of payment doctrine as a rationale for authorizing payment of prepetition obligations. *See In re Kmart Corp.*, 359 F.3d 866, 871, 2004 U.S. App. LEXIS 3397 *11 (7th Cir. 2004) ("A 'doctrine of necessity' is just a fancy name for a power to depart from the Code."). *See P 6.04[2] infra* for a detailed discussion of "critical vendor" first day orders in prepackaged bankruptcy cases. *See P 9.08 infra* for a further discussion of first day motions and orders generally.

(n30)Footnote 30. 11 U.S.C. § 546(c), as amended by Pub. L. No. 109-390 (2006), effective in cases commenced on or after December 12, 2006. Pub. L. No. 109-8 (2005) continues to be effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised) ("2005 Act"). Prior to the 2005 Act, the bankruptcy court could deny the seller's reclamation request if the court provided the seller with either an administrative expense priority claim or a lien. The 2005 Act appears to end the bankruptcy court's discretion in this regard, suggesting that the debtor must actually return the goods in question. *See id.* Furthermore, the 2005 Act contains explicit recognition that a seller's right of reclamation is subject to the prior rights of a holder of a security interest in the reclaimed goods and provides that a debtor's right to return goods shipped prior to the commencement of a case is subject to the rights of a holder of such a security interest. 11 U.S.C. § 546(c), (h). As a practical matter, it is unlikely that many debtors will return goods because vendors rarely want their goods back, and, in most cases, it is in the parties' mutual interest to negotiate another resolution. Such negotiations, however, are likely to place a substantial additional burden on the debtor's time and cash resources in many cases.

(n31)Footnote 31. *See 11 U.S.C. §§ 546(c)(2), 503(b)(9).*

(n32)Footnote 32. 11 U.S.C. § 503(b)(1)(A)(i), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; *see also* 11 U.S.C. § 507(a)(2), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n33)Footnote 33. *See 11 U.S.C. § 364(a).*

(n34)Footnote 34. The debtor's ability to make these adjustments is subject to a number of limitations. First, the approval of the bankruptcy court is required. 11 U.S.C. § 365(a). Second, the debtor's ability to adjust certain types of contracts is restricted. *See 11 U.S.C. § 365(b)(3)* (lease of real property in a shopping center); 11 U.S.C. § 365(n) (licenses of intellectual property); 11 U.S.C. § 555 (securities contracts); 11 U.S.C. § 556 (commodities contracts); 11 U.S.C. § 559 (repurchase agreements); 11 U.S.C. § 560 (swap agreements); 11 U.S.C. § 1113 (collective bargaining agreements).

(n35)Footnote 35. *See P 1.06[3] supra* for a definition of "executory contract."

(n36)Footnote 36. 11 U.S.C. § 365(a).

(n37)Footnote 37. *11 U.S.C. § 365(g)*. In the case of employment contracts and leases of non-residential real property, the amount of this damage claim is significantly limited by provisions of the Bankruptcy Code. *See 11 U.S.C. § 502(b)(6) & (7)*.

(n38)Footnote 38. *11 U.S.C. § 365(a)*.

(n39)Footnote 39. *11 U.S.C. § 365(b)(1)*.

(n40)Footnote 40. *11 U.S.C. § 365(b)(2)*.

(n41)Footnote 41. *11 U.S.C. § 365(f)*.

(n42)Footnote 42. *11 U.S.C. § 365(k)*.

(n43)Footnote 43. *11 U.S.C. § 365(f)*. For certain kinds of contracts, such as personal service contracts and contracts to make loans, the debtor's ability to assume or assign may be limited by the terms of the contract. *See 11 U.S.C. § 365(e)(2)*.



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Collier Business Workout Guide

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CHAPTER 2 Initiating the Workout

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P 2.07 Finances of the Troubled Company During the Restructuring.

A workout and a bankruptcy reorganization affect the finances of a troubled company in very different ways. These differences should be measured from two perspectives: the short-term effect on the troubled company's liquidity and the long-term effect on the troubled company's balance sheet.

[1] Impact of the Restructuring on the Troubled Company's Liquidity.

[a] Revenue.

Many companies in financial distress require new financing. In a workout, the troubled company's ability to raise additional funds quickly is limited. It has available to it only those means generally available to businesses--new borrowings, sales of assets, cost-cutting, and an increase in its operational revenue. In most cases, the company's financial distress will restrict, or even eliminate, the company's access to these conventional tools.

In the best of times, a rapid increase in operating revenue is difficult. For a company in financial distress and suffering through the attendant negative publicity, it is next to impossible. It is far more likely that the troubled company will be forced to contend with a decline in operating revenue.

Similarly, most conventional sources of borrowing will be unavailable to the troubled company. An unsecured financing of any sort will be out of the question. The only avenue that may be available to the troubled company is a secured loan or an equivalent transaction such as a sale of accounts receivable. This will be a possibility only if the troubled company has unencumbered assets. In addition, the troubled company will require the cooperation of its institutional lenders. In many cases, the company's existing debt agreements will contain negative pledge provisions that effectively prohibit the incurrence of any additional secured debt. Even when such provisions do not exist, the troubled company's need for the cooperation or forbearance of its institutional lenders will probably preclude any financing to which they do not consent.

Finally, even a sale of assets is fraught with problems for a company in financial distress. Many troubled companies simply do not own any significant, readily saleable assets. Even when marketable assets are available, the troubled company may have difficulty obtaining an acceptable price. Its financial distress and obvious need to consummate the transaction may create a "fire sale" atmosphere, discouraging bidders from offering a full price. The possibility of an eventual bankruptcy case may also deter bidders. Otherwise interested parties may decline to make an offer because of

concerns about the company's ability to deliver clean title to the assets being sold.ⁿ¹

The initiation of a case under the Bankruptcy Code usually aggravates a company's need for new financing. The negative publicity attendant to the filing of the petition for relief generally triggers a variety of actions by customers and suppliers. Some customers will delay or stop payment of receivables. Others will simply shift their business to competitors. Many suppliers will refuse to provide goods and services except for immediate cash payment. In the aggregate, these steps may significantly reduce the debtor's liquidity, at least in the near-term.

However, aware of the many problems facing a company at the commencement of a case under the Bankruptcy Code, the drafters of the Bankruptcy Code sought to provide debtors with several special financing tools. *Section 364 of the Bankruptcy Code* permits a debtor seeking new financing to offer potential lenders a variety of inducements. At the very least, the debtor may offer postpetition lenders an administrative priority, placing their claims ahead of unsecured prepetition claims and most other priority claims.ⁿ² If financing cannot be obtained on this basis, the debtor may offer the postpetition lender a priority over other administrative expenses or a lien on property of the debtor's estate.ⁿ³ If even this is insufficient to induce the extension of necessary credit, the debtor may offer the postpetition lender a "priming" lien or a lien senior to existing liens.ⁿ⁴

The drafters of the Bankruptcy Code also sought to enhance the debtor's ability to sell or lease assets during a bankruptcy reorganization. Under *section 363 of the Code*, the debtor may sell or lease assets outside of the ordinary course of business so long as it obtains the consent of the bankruptcy court.ⁿ⁵ The debtor may do so notwithstanding provisions in its debt agreements or other contracts that prohibit or restrict such actions. Moreover, subject to certain limitations, the debtor may sell assets free and clear of liens and other encumbrances.ⁿ⁶ As a result of these provisions, the debtor can provide the purchaser with a court order officially awarding the purchaser good and valid title to the assets purchased.

[b] Expenses.

[i] Trade Credit.

Among a troubled company's most serious concerns is the continued availability of trade credit. If news of the company's financial distress spreads to its suppliers, the company will often experience a tightening or elimination of credit terms. Many trade creditors will seek to accelerate the company's payment obligations. In some cases, trade creditors may only supply goods and services on a "cash and carry" basis.

In a workout, so long as liquidity is not already constrained, the troubled company can usually control this problem. As will be discussed below,ⁿ⁷ news of the company's troubles can be managed to prevent supplier panic. Often, a judicious extension of trade payables is even possible.

The negative publicity created by the filing of a petition under the Bankruptcy Code will generally aggravate the debtor's problems. Suppliers that were previously unaware of the debtor's financial distress will be focused on the debtor's condition. Many will refuse, at least initially, to supply goods and services except for immediate cash payment. Some may refuse to supply on any terms. In addition, by freezing the debtor's prepetition obligations to its trade creditors, the filing may stimulate new problems. For instance, some suppliers may seek to recoup a portion of their prepetition claim by raising prices to the debtor or otherwise altering terms.

While not a complete solution to the debtor's problems, the Bankruptcy Code does protect the debtor's access to trade credit in two important ways. First, the Bankruptcy Code preserves the trade financing enjoyed by the debtor as of the filing date. As indicated, the filing of a bankruptcy petition acts to freeze all prepetition obligations of the debtor. This serves to lock the trade credit existing on the petition date in place for the duration of the bankruptcy case. Although the debtor is subject to trade creditors' statutory reclamation rights,ⁿ⁸ the debtor will continue to enjoy this financing until

the conclusion of the case even if going forward all of its trade creditors refuse to supply goods and services except in return for immediate cash payment.

Moreover, the Bankruptcy Code actually encourages trade creditors to continue to extend new credit subsequent to the filing of the petition for relief. Under section 364(a) any obligation incurred by the debtor in the ordinary course of business is accorded an administrative priority.ⁿ⁹ This entitles the beneficiary of the obligation to payment ahead of all unsecured prepetition creditors and most priority claimants. If the debtor has significant unencumbered assets, this priority may be sufficient to encourage creditors to continue to offer credit after the commencement of the bankruptcy case. Further, section 364 permits the debtor to obtain additional loans. When this new financing is available to support payments to suppliers, it provides an even more powerful inducement to the continued extension of trade credit.

[ii] Debt Service.

A key element in any program to increase liquidity (whether implemented in an out-of-court restructuring or in bankruptcy) is the deferral of debt service payments. Payments of principal and interest on the troubled company's borrowed-money debt are often among the company's largest expense items and usually one of the most easily manipulated. In contrast to the deferral of many other expenses, such as capital expenditures, salaries and the like, the failure to make these payments in a timely manner has little or no direct impact on the troubled company's operations.

In a workout, these payments can only be deferred with the consent, or at least acquiescence, of the lenders affected. The documents governing the loans will entitle the lenders to exercise remedies upon any failure by the troubled company to make a scheduled payment of principal or interest. Consequently, when institutional lenders are involved, the troubled company may seek to negotiate a formal standstill. In the case of payments owing to the holders of public debt securities, this is not practical and the company will be forced to act unilaterally. However, the deferral will only succeed if the holders of the securities acquiesce in the company's action.

In a bankruptcy reorganization, the debtor is no longer at the mercy of its lenders. As with other liabilities, the filing of the bankruptcy petition serves to freeze the debtor's debt service obligations. Except when a secured lender is entitled to adequate protection payments, the debtor need not remain current on its scheduled payments of principal and interest.ⁿ¹⁰

[iii] Transaction Costs.

The demanding procedural requirements of a chapter 11 case make a bankruptcy reorganization extraordinarily lawyer intensive. Transactions that could be undertaken in normal times (or even in a workout) without the assistance of counsel, can only proceed after the debtor has provided all parties in interest with notice and an opportunity to be heard. In addition, decisions that usually could be made unilaterally by the debtor's board of directors now must be debated with the official committee of unsecured creditors and other constituencies. Matters that might normally be resolved quickly and efficiently are extraordinarily contentious and time consuming. As a result, the debtor's transaction costs in a bankruptcy reorganization are often considerable.ⁿ¹¹

[2] Impact of the Restructuring on the Troubled Company's Balance Sheet.

The impact of the commencement of a bankruptcy case on the debtor's balance sheet is mixed. By giving rise to causes of action not available to the debtor outside of bankruptcy, initiation of the case may enhance the asset side of the debtor's balance sheet. In addition, liabilities with which the debtor was forced to contend before the filing of the petition for relief may be subordinated, reduced or even eliminated in bankruptcy. However, commencement of a case under the Bankruptcy Code can also give rise to claims that would not normally have been asserted in a workout. These claims may be significant in number and amount.

[a] Assets.

The commencement of a workout does not alter the property rights of the company. The company retains legal title to those assets it owned in better times. Of course, during the course of the restructuring, the company's holdings may be affected. Capital spending may be reduced causing a deterioration in the company's plant and machinery. Secured creditors may seek to foreclose on their collateral. The company may be forced to sell assets in order to enhance liquidity. However, the company's property rights are neither reduced nor enlarged by the mere fact of the restructuring.

The debtor's existing property interests also survive the filing of a bankruptcy petition intact. Under *section 541 of the Bankruptcy Code*, the commencement of a case creates an "estate." This "estate" is comprised of all of the "legal or equitable interests of the debtor in property as of the commencement of the case."¹² In fact, the debtor's property interests may be expanded by the filing. Under the Bankruptcy Code, the debtor's estate also includes certain causes of action that either did not exist or did not belong to the debtor prior to the commencement of the bankruptcy case.¹³ The debtor may seek to avoid preferential.¹⁴ and fraudulent transfers.¹⁵ In addition, the Bankruptcy Code affords the debtor the right to void unperfected liens¹⁶ and certain preferential prepetition setoffs.¹⁷ Through the exercise of these "avoiding powers," the debtor has the right to have the offending prepetition transfer voided and the property conveyed restored to the estate. In some cases, the transfers and obligations subject to avoidance may be of substantial size and these claims will be of significant value to the estate.¹⁸ In such event, the availability of these causes of action should weigh heavily in the troubled company's consideration of whether to commence a bankruptcy case, unless the company believes it can negotiate an out-of-court restructuring that properly reflects the vulnerabilities of its various creditors.

[b] Liabilities.

The commencement of a case under the Bankruptcy Code affects the liability side of the debtor's balance sheet in a variety of ways.¹⁹

[i] Claims Generation.

Typically, the commencement of an out-of-court restructuring does not have a dramatic effect on the troubled company's liabilities, although news of the company's financial distress may have an impact. For instance, creditors concerned about the company's survival may demand accelerated payment. However, the company's liabilities are not affected by the restructuring process itself.

A bankruptcy reorganization, however, has a different impact. Certain features of a bankruptcy reorganization act to generate additional liabilities. First, the Bankruptcy Code and the Bankruptcy Rules outline an elaborate system for precisely defining the debtor's liabilities. In order to receive a distribution in the bankruptcy case, creditors are required to either accept the debtor's valuation of their claim or file a written statement setting forth various information with respect to their claim, or "proof of claim."²⁰ Proofs of claim must be filed on or before a date set by the bankruptcy court, or "bar date."²¹ Claims that are not evidenced by a timely filed proof of claim are forever barred from recovery.²² To insure that creditors are aware of the bar date and the procedures for filing proofs of claim, the debtor must provide notice by direct mail and, in some cases, by publication.²³ The bar date and the extensive notice of its impact generally stimulate the assertion of a large number of unexpected claims. Receipt of the notice may cause some creditors to review their records concerning the debtor. In so doing, they may discover claims that might otherwise have been forgotten. The bar date and the specter of losing for all time one's claims against the debtor may cause other creditors to assert claims that are speculative or subject to dispute.

The broad scope of a bankruptcy reorganization may also generate additional liabilities. A workout usually focuses exclusively on fixed and liquidated liabilities. A bankruptcy reorganization, in contrast, encompasses all of the obligations of the debtor, whether fixed or contingent, liquidated or unliquidated, disputed or undisputed. The provisions of a confirmed plan of reorganization bind all creditors of the debtor and, subject to certain exceptions, the

plan of reorganization serves to discharge all debts of the debtor arising before the date of confirmation.ⁿ²⁴ Consequently, in a bankruptcy reorganization, the debtor must provide for various contingent or unliquidated claims with which it might never be forced to deal under normal operating conditions. Certain of these claims--tax, pension and environmental liabilities, for instance--may be substantial.

[ii] Claims Adjustment.

Initiation of a workout affects neither the amount nor the priority of a troubled company's obligations. Interest continues to accrue on the company's borrowed-money obligations whether or not paid. The mere fact of the company's financial distress does not relieve it of its legal obligation to compensate the other party to a contract or lease in the event of a material breach. Only through a consensual arrangement with a creditor can the company alter the amount or priority of its obligation.

In a bankruptcy reorganization, however, the simple act of filing the petition significantly alters a number of the debtor's most substantial obligations:

- Except when the debtor is solvent, unsecured and undersecured claims cease to accrue interest or, in the case of obligations issued with original issue discount, accrete.ⁿ²⁵
- Claims arising from the rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor or for damages arising from the purchase or sale of such a security are subordinated to all claims or interests that are senior to or equal to the claim or interest represented by such security.ⁿ²⁶
- Claims for fines, penalties or forfeiture, or for multiple, exemplary or punitive damages may be subordinated to all unsecured prepetition claims except to the extent that the fine, penalty, forfeiture or damages are compensation for actual pecuniary loss suffered by the holder.ⁿ²⁷
- The bankruptcy court may under principles of equitable subordination subordinate all or part of any allowed claim or interest to all or part of any other allowed claim or interest.ⁿ²⁸
- Damages resulting from the termination of a lease of real property are limited to the sum of all unpaid rent due under the lease, without acceleration, on the earlier of the filing date or termination of employment, plus the rent reserved under the lease, without acceleration, for the greater of one year or 15% (not to exceed three years) of the remaining term of the lease.ⁿ²⁹
- Damages resulting from the termination of an employment contract are limited to the sum of any unpaid compensation due under the contract, without acceleration, on the earlier of the filing date or termination of employment, plus the compensation provided by such contract, without acceleration, for one year following the earlier of the filing date or termination of employment.ⁿ³⁰

These provisions of the Bankruptcy Code can in certain circumstances substantially reduce a debtor's liabilities. In addition, by subordinating certain obligations, these provisions may substantially alter priorities. A troubled company with significant obligations of the relevant types must seriously consider the impact of the commencement of a case under the Bankruptcy Code on these obligations in determining how best to restructure.

[iii] Substantive Consolidation.

On rare occasions, the initiation of a case under the Bankruptcy Code may result in an even more dramatic rearrangement of the debtor's balance sheet. The equitable doctrine of substantive consolidation permits a bankruptcy court in a case involving related corporate entities to disregard the separateness of the entities.

In determining whether to substantively consolidate these separate entities, the bankruptcy court must make at least one of two difficult findings, based on the consolidation proponent's showing. First, the court must find that prepetition, the entities disregarded separateness so significantly that their creditors relied on the breakdown of entity borders and treated them as one legal entity when prepetition credit was given.ⁿ³¹ Alternatively, the court must find that, postpetition, the assets and liabilities of the separate entities are so "scrambled" that separating them is prohibitive and hurts all creditors.ⁿ³²

Substantive consolidation is an equitable remedy, to be applied only sparingly.ⁿ³³ However, when applied, it results in a total transformation of the debtor's balance sheet. The legal separateness of the debtor is ignored and its assets and liabilities are consolidated with those of the relevant related entities. In so doing, the net worth of the debtor can be dramatically altered. In some cases, the debtor's creditors may find themselves sharing the assets to which they looked for satisfaction of their claims with a far larger number of claimants. In other cases, the pool of assets available for distribution to the debtor's creditors may be substantially increased.

FOOTNOTES:

(n1)Footnote 1. Potential buyers may fear attempts by creditors to lay claim to the assets purchased on fraudulent conveyance or similar grounds. See *P 4.06 infra* for a discussion of fraudulent conveyance law.

(n2)Footnote 2. 11 U.S.C. § 364(b).

(n3)Footnote 3. 11 U.S.C. § 364(c).

(n4)Footnote 4. 11 U.S.C. § 364(d). A priming lien can only be granted if the holder of the prepetition lien is adequately protected. *Id.* Section 361 of the Bankruptcy Code describes the means by which adequate protection may be provided. 11 U.S.C. § 361. In this context, adequate protection is usually provided by requiring that after incurrence of the priming lien sufficient equity remains in the collateral to protect the existing lien holder.

While not explicitly authorized by the Bankruptcy Code, bankruptcy courts have on occasion permitted debtors to offer other inducements, particularly to the debtor's prepetition lenders. One form of inducement that debtors have sought to use in obtaining credit is "cross-collateralization," i.e., granting liens on prepetition or postpetition property to secure (or further secure) prepetition debt. See *In re Adams Apple, Inc.*, 829 F.2d 1484, 1488 (9th Cir. 1987) ; *In re Defender Drug Stores, Inc.*, 145 B.R. 312, 316-317 (B.A.P. 9th Cir. 1992) . Some courts have allowed cross-collateralization despite the risk that elevating an unsecured or undersecured prepetition loan to fully secured status may dramatically alter the prepetition priorities. See, e.g., *In re Ames Dep't Stores, Inc.*, 22 C.B.C.2d 1500, 1507, 115 B.R. 34, 39 (Bankr. S.D.N.Y. 1990) ; *In re Vanguard Diversified, Inc.*, 31 B.R. 364 (Bankr. E.D.N.Y. 1983) . But see *In re Saybrook Mfg. Co.*, 963 F.2d 1490, 27 C.B.C.2d 277 (11th Cir. 1992) (cross-collateralization violates the priority scheme of the Bankruptcy Code). For further discussion of cross-collateralization in the context of chapter 11, see *P 9.08[6][b][ii] infra*.

In addition, courts have permitted debtors to acknowledge the validity of a prepetition lender's prepetition claims and liens. See *In re Ellingsen MacLean Oil Co.*, 834 F.2d 599, 604, 17 C.B.C.2d 1402, 1408-09 (6th Cir. 1987) , cert. denied sub nom. *Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co.*, 488 U.S. 817, 109 S. Ct. 55, 102 L. Ed. 2d 33 (1988) . But see *Ames Dep't Stores*, 22 C.B.C.2d at 1505, 115 B.R. at 38 ; *In re Tenney Village Co.*, 104 B.R. 562, 568-69 (Bankr. D.N.H. 1989) . See *P 1.06[2] supra* and *P 9.08[6][b] infra* for a more detailed discussion of debtor-in-possession financing.

(n5)Footnote 5. 11 U.S.C. § 363(b); see also *P 1.06[1] supra*.

(n6)Footnote 6. 11 U.S.C. § 363(f).

(n7)Footnote 7. *See P 2.08[2] infra.*

(n8)Footnote 8. *See P 2.06[4] supra* for a detailed description of trade creditor reclamation rights as provided in the Bankruptcy Code.

(n9)Footnote 9. *11 U.S.C. § 364(a).*

(n10)Footnote 10. In some cases, the debtor will never be required to make payment. If the lender's claim is unsecured or undersecured, interest on the claim will stop accruing on the filing date. *See 11 U.S.C. § 502(b)(2).*

(n11)Footnote 11. *See generally*, Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. Empirical Legal Stud. 111, 113 (2004) (In large chapter 11 cases, ratio of professional fees and expenses to total assets averages about 2.0%). To take an extreme example, during the first 13 months of the Enron bankruptcy case, professional fees totaled \$318,000,000, or approximately \$815,000 per calendar day. *Id.* at 128, n.58 (citing Douglas Feiden, *Cashing in Big-Time on Enron's Collapse: Gravy Train for Lawyers & Accountants*, DAILY NEWS (New York), Feb. 2, 2003 at 8); *see also* MCI Inc. Asks Court To Approve \$600 Million In Professional Fees, DAILY BANKR. REV., Aug. 18, 2004, at 4 (reporting on final retained professionals' fees, accrued over approximately two years in MCI Inc.'s (formerly WorldCom Inc.) bankruptcy cases).

(n12)Footnote 12. *11 U.S.C. § 541(a)(1).*

(n13)Footnote 13. *See 11 U.S.C. § 541(a)(3), (4).*

(n14)Footnote 14. *11 U.S.C. § 547.*

(n15)Footnote 15. *11 U.S.C. § 548.*

(n16)Footnote 16. *11 U.S.C. § 544(a)(1).*

(n17)Footnote 17. *11 U.S.C. § 553(b).*

(n18)Footnote 18. *See PP 4.03[5] and 4.06 infra* for a discussion of the contexts in which these issues may be of particular significance.

(n19)Footnote 19. The troubled company's tax obligations are among the most significant liabilities affected by the filing of a petition for relief. *See ch. 8 infra.*

(n20)Footnote 20. *11 U.S.C. § 1111(a); Fed. R. Bankr. P. 3003(c). See also Interim Rule 3003(c). See generally P 1.07[3] supra.*

(n21)Footnote 21. *Fed. R. Bankr. P. 3003(c)(3). See also Interim Rule 3003(c).*

(n22)Footnote 22. *Fed. R. Bankr. P. 3003(c)(2).*

(n23)Footnote 23. The Federal Rules of Bankruptcy Procedure require that the debtor provide 20 days notice to all creditors by mail. *Fed. R. Bankr. P. 2002(a)(7)*. The bankruptcy court may permit notice by publication if notice by mail is impracticable or it is desirable to supplement the notice. *Fed. Bankr. P. 2002(l)*.

(n24)Footnote 24. *11 U.S.C. § 1141(a) and (d).*

(n25)Footnote 25. *11 U.S.C. § 502(b)(2).*

(n26)Footnote 26. *11 U.S.C. § 510(b)*. These provisions may require subordination of a variety of claims, including, for example, securities fraud claims, claims arising under a stock purchase agreement and claims arising from

breach of a merger agreement. See *Frankun v. Int'l Wireless Communs. Holdings, Inc. (In re Int'l Wireless Communs. Holdings, Inc.)*, 68 Fed. Appx. 275, 278, 2003 U.S. App. LEXIS 12431 (3d Cir. 2003) ; *American Broad. Sys. v. Nugent (In re Betacom of Phoenix, Inc.)*, 240 F.3d 823 (9th Cir. 2001) ; *In re PT-1 Communs., Inc.*, 304 B.R. 601, 607-09 (Bankr. E.D.N.Y. 2004) ; *In re Enron Corp.*, 341 B.R. 141, 162-63, 2006 Bankr. LEXIS 1340, *65-71 (Bankr. S.D.N.Y. 2006) ; *Rombro v. Dufrayne (In re Med Diversified, Inc.)*, 2006 U.S. App. LEXIS 21702, *14-23 (2d Cir. Aug. 25, 2006) . Note, however, that if such claims relate to the debtor's common stock, they are treated in the same manner and with the same priority under the reorganization plan as common stock.

(n27)Footnote 27. 11 U.S.C. § 726(a)(4). The applicability of section 726(a)(4) to cases under chapter 11 is unclear. Compare *In re American Fed'n of Television & Radio Artists*, 9 C.B.C.2d 299, 32 B.R. 672 (Bankr. S.D.N.Y. 1983) (holding section 726(a)(4) inapplicable to cases under chapter 11) with *In re Compton Corp.*, 10 C.B.C.2d 1239, 40 B.R. 875, 876-77 (Bankr. N.D. Tex. 1984) , *rev'd on other grounds*, 90 B.R. 798, 800-02 (N.D. Tex. 1988) (holding section 726(a)(4) applicable to cases under chapter 11).

(n28)Footnote 28. 11 U.S.C. § 510(c).

(n29)Footnote 29. 11 U.S.C. § 502(b)(6).

(n30)Footnote 30. 11 U.S.C. § 502(b)(7).

(n31)Footnote 31. *In re Owens Corning*, 419 F.3d 195, 211 (3d Cir. 2005) . In *In re Owens Corning*, the United States Court of Appeals for the Third Circuit reversed the decision of the United States District Court for the District of Delaware and held that substantive consolidation was not warranted under the circumstances of the case. With respect to the first prong of its test for substantive consolidation, the Third Circuit court concluded that there was no evidence of prepetition disregard of the separateness of the Owens Corning entities. In justifying this conclusion, the Third Circuit court relied in large part on evidence that the creditors' assessment of the value of various credit guarantees was based partially on the separateness of the Owens Corning entities. *Id.* at *212-213 . The Third Circuit court went further and applied the second prong of its substantive consolidation test, thereafter concluding that there is no meaningful evidence of postpetition commingling of assets and liability among the Owens Corning entities because there is no question about which entity owns which principal assets and has which material liabilities. *Id.* at 214 . Accordingly, the Third Circuit court rejected the District Court's conclusion that commingling of assets alone justifies consolidation when "the affairs of the two companies are so entangled that consolidation will be beneficial" on several grounds. *Id.* First, the Third Circuit reiterated the principle that commingling justifies consolidation only when separately accounting for the assets and liabilities of the distinct entities will reduce the recovery of every creditor, that is, every creditor will benefit from the consolidation. *Id.* . Second, the Third Circuit stated that the benefit to creditors should be from cost savings that make assets available rather than from the shifting of assets to benefit one group of creditors at the expense of another. *Id.* Third, the Third Circuit opined that the District Court's test suffered from the infirmity that it will almost always be met, that is, substantive consolidation will nearly always produce some benefit to some in the form of simplification and/or avoidance of costs. *Id.*

But see, e.g., Eastgroup Properties v. Southern Motel Assoc., Ltd., 935 F.2d 245, 249-50, 25 C.B.C.2d 158, 163-64 (11th Cir. 1991) , where the court granted substantive consolidation using a test applied in several jurisdictions. Under the *Eastgroup* test, the proponent of substantive consolidation must show that (1) there is substantial identity between the entities to be consolidated and (2) consolidation is necessary to avoid some harm or to realize some benefit. *Id.* at 249 . When this showing is made, a presumption arises "that creditors have not relied solely on the credit of one of the entities involved." *Id.* In establishing its prima facie case, a consolidation proponent can use the presence or absence of consolidated financial statements; the unity of interests and ownership between various corporate entities; the existence of parent and inter-corporate guarantees on loans; the degree of difficulty in segregating and ascertaining individual assets and liabilities; the existence of transfers of assets without formal observance of corporate formalities; the commingling of assets and business functions; and the profitability of consolidation at a single physical location. *Id.* Once the proponent has made its prima facie case for consolidation, the burden shifts to an objecting creditor to show

that (1) it has relied on the separate credit of one of the entities to be consolidated and (2) it will be prejudiced by substantive consolidation. *Id.* Finally, if an objecting creditor has made this showing, "the court may order consolidation only if it determines that the demonstrated benefits of consolidation 'heavily' outweigh the harm." *Id.*

(n32)Footnote 32. *In re Owens Corning*, 419 F.3d 195, at 211 .

(n33)Footnote 33. *In re Owens Corning*, 419 F.3d 195, at 208-209 .



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Collier Business Workout Guide

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CHAPTER 2 Initiating the Workout

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P 2.08 How Is the Workout Commenced?

The third task that confronts counsel during the early stages of any restructuring is advising the troubled company concerning the steps to be taken in initiating the restructuring process. While the precise nature of what is required will depend upon how the company and its counsel resolve the issues discussed in the preceding sections of this chapter, counsel must usually begin wrestling with this problem before definitive answers are available. The press of events will generally not permit counsel the luxury of dealing with these matters sequentially. In addition, certain elements of the analysis underlying the troubled company's decisions whether or not to restructure and how best to restructure cannot be produced until the initial steps in the restructuring process are taken.

[1] Creating the Restructuring Team.

The first step to be taken in the restructuring process is the creation of the restructuring team. A restructuring can require months, if not several years, to complete. In addition, through much of this period, the restructuring may demand almost daily attention. As a result, it is essential that the troubled company identify a team of individuals specifically responsible for overseeing the restructuring through its entire course.

At the core of the restructuring team will be members of the troubled company's management. These individuals will provide day-to-day supervision of the restructuring and will serve as liaisons between the company and its creditors and other constituencies. The management resources of the company will ultimately dictate who is chosen to fill these roles. In smaller companies, management's only option may be to charge its most talented member with the responsibility, whatever his or her background and other responsibilities. To the extent possible, however, the management members of the restructuring team should be selected with the required functions in mind. These individuals will represent the company in discussions with its major creditors. Consequently, they should have the seniority and authority necessary to earn the respect of these creditors. Because of the demands of the restructuring process, the management members of the restructuring team ideally should have limited responsibility for the day-to-day operations of the company's business. Discussions between the restructuring team and creditors will focus primarily on the company's capital structure and finances. As a result, the management members of the restructuring team should be able to speak knowledgeably on these subjects. Finally, these individuals should be temperamentally suited for the role they will play. In any restructuring, the troubled company frequently will be the focus of anger and frustration. Sometimes this can be deflected to other members of the restructuring team. However, the management members of the team must be capable of coping with this treatment as well.

In the selection of the management members of the restructuring team, a pivotal issue will be the extent of the participation of the company's chief executive officer. The chief executive officer must, of course, be consulted regularly concerning the team's activities. However, when the management resources of the company and the temperament of the chief executive officer permit, it is usually preferable that the chief executive officer's interaction with creditors and other constituencies be limited to pivotal points in the restructuring. This provides the restructuring team with a negotiating tool that can be held in reserve to break deadlocks and for other special occasions.

Whatever the talents of the management members of the restructuring team, they will require the assistance of outside professionals. Even in the best run companies, management will have little, if any, experience with the problems and pressures it will confront in a restructuring. Consequently, if the restructuring is to succeed, management must have available to it the expertise of professionals with significant experience in the area. Restructurings are lawyer intensive, and the company will need the assistance of legal counsel. Generally, the restructuring team should also include an accountant. In more complex workouts, the company will require independent financial analysis in order to review properly the options available to it, and an investment banking firm should be retained. Whether other professionals are required will depend on the particular company and its circumstances. For example, when management resources are limited or management has lost the confidence of the company's major creditors, it may be appropriate to retain an outside management consultant or crisis manager. In some cases, a consultant or crisis manager is used as a management surrogate, filling the management place on the restructuring team. When the company is of substantial size and publicity concerning the restructuring is likely to be significant, a public relations firm skilled in handling the problems of a company in financial distress may be essential.

[2] Communications.

Among the first tasks awaiting the newly-formed restructuring team will be that of structuring communications between the troubled company and its many constituencies concerning the company's predicament. In all likelihood, news of the company's financial distress will have already spread among the company's employees. In addition, depending on the prominence and size of the company in question, word of the company's problems may have reached its external constituencies--customers, suppliers and creditors. Unless the restructuring team acts decisively to influence the timing and content of this publicity, the company may suffer serious damage. Misinformation concerning the company's condition may spread. Even when the information disseminated is accurate, it may be presented in an unnecessarily negative light.

Often, by the time that the restructuring team has formed, substantial damage will have already been done. The instinctive reaction of many companies under stress is to close ranks. The flow of information to external constituencies is restricted or even cut off in the hope that the company can effectively restrict knowledge of its problems to senior management. In some cases, this approach succeeds, at least for a time. If a company's operating business is fundamentally sound and it must simply renegotiate the terms of certain privately-held indebtedness, the workout negotiations may be restricted to the company's institutional lenders. In these situations, the company's employees and trade creditors may be unaware of the company's problems. Frequently, however, efforts to restrict the dissemination of information are futile. News of the company's distress spreads simply through the company's ordinary-course dealings with the outside world. In some instances, financial statements provided to lenders or regulatory authorities may disclose the company's deteriorating financial condition. Often, a company's independent public accountants will qualify their report on the company's financial statement with a "going concern limitation," an explanatory paragraph noting uncertainty about the company's ability to continue as a going concern. In other instances, trade creditors may detect an aging of the company's payables or customers may experience problems with the availability of goods and services.

More important, efforts to cut off information flow are often counterproductive. Among the troubled company's most valuable assets is its credibility. Any workout is in large measure an exercise in persuasion. The company must

convince its creditors and other constituencies that by relinquishing, or deferring the exercise of, various rights they will ultimately realize a greater return on their claims than if they seek immediately to exercise their contractual remedies. Unless the company earns and retains the trust of these constituencies, negotiation and implementation of the restructuring will be infinitely more difficult and in some cases impossible. There is no quicker way to lose a claimant's trust than to restrict its access to information.

Consequently, the restructuring team must act promptly to open communications internally and externally. This does not mean that the activities of the restructuring team must be an open book. Much of the restructuring team's time will be spent dealing with problems of only short-term significance and considering restructuring options that are ultimately abandoned. Dissemination of information concerning these activities would be unhelpful or even confusing to most interested parties. The restructuring team's goal should be the formulation of a communications program that provides each constituency with the information appropriate to its concerns and level of sophistication.

[a] Communication With Employees.

The troubled company's employees are likely to be unsophisticated about the restructuring process and how it might affect their relationship with the company. This lack of sophistication has a number of implications. First, it will be important for the company to explain carefully the nature of the process on which it is about to embark. What are the company's problems? How does the company propose to treat these problems? Is bankruptcy a possibility? Will the company's operations be affected? The company's employees are unlikely to have had any significant prior experience with a restructuring, and they may be confused about even the most basic aspects of the process.

Second, to the extent possible, the company must explain to its employees how the restructuring is likely to affect them. Are significant layoffs anticipated? Does the company have sufficient funds to pay wages and other employee compensation? Obviously, it is important to put a positive spin on these messages to the extent possible. However, absent official statements by the company on these issues, rumors will circulate and the rumors may be worse than reality.

[b] Communication With Creditors.

The troubled company's creditors, whether trade creditors or lenders, are likely to be more knowledgeable than the company's employees. As a result, a more sophisticated communications effort will be required.

[i] Lenders.

The first problem the restructuring team must confront in formulating a communications program for its lenders is the selection of the lenders to be targeted. The resolution of this issue will turn on the answer to two questions. With respect to which of its obligations is the company in default? Which of its obligations will the company seek to restructure in the workout? When the company cannot or will not comply with its obligations to a lender, the lender will demand an explanation. This is the central purpose of the communications program.

When should the troubled company first approach the targeted lenders? The press of events may ultimately dictate the timing of the initial communication. To the extent possible, however, the company should seek to balance two competing concerns.

First, the initial approach should not be too early. If at all possible, the company should try to delay the first meeting with its lenders until it is prepared to do something more than impart bad news. At very least, the company should be prepared with a preliminary assessment of its problems. What has gone wrong? What does it mean for the company and its lenders--short-term and long-term? Ideally, the company should also be ready with preliminary thoughts concerning how it might deal with its problems. The lenders will not expect a formal restructuring proposal. But they will

appreciate answers to some basic questions concerning the company's direction. How does the company propose to restructure, out-of-court or in bankruptcy? Which obligations will the company seek to renegotiate? What steps have been taken in the restructuring process? To the extent the company can create the impression that it has methodically identified and analyzed its maladies, it will have gone a long way towards blunting the initial impact of the news of its financial distress.

However, in seeking to develop a preliminary plan for presentation to its lenders, the troubled company must not delay the initial communication too long. It is important that the company break the bad news to its lenders before its financial distress becomes manifest. In some cases, this may not be possible. A working capital lender that monitors the company's inventory levels and receivables collections may detect the company's problems before management does. If it can be provided, however, an advance warning will build confidence in management by suggesting that management can recognize problems early. A surprise default, in contrast, will undercut the very impression of control and competence the company is striving to create.ⁿ¹

The agenda for the troubled company's initial contacts with its lenders should have three basic components. First, the company must acquaint its lenders with the details of its financial distress. To the extent possible, this presentation should be combined with the type of preliminary restructuring analysis already described.

Second, whether or not the company is prepared to present preliminary ideas concerning a restructuring, it must provide its lenders with a detailed description of what they can expect during the next few months. Will the company request additional funding? Will interest and principal payments on outstanding loans be made according to existing terms? Will the company default on any of its other obligations?

Finally, the troubled company's initial contacts with its lenders should focus on structuring the participation of the lending community in the workout. The largest or lead lenders should be encouraged to organize a committee to negotiate the restructuring on behalf of the lenders. The company should indicate whether it is willing to bear the costs of the committee's legal counsel and other advisors. The timing and scope of the committee's due diligence must be negotiated.

[ii] Trade Creditors.

The troubled company's cash flow and general financial condition will determine the appropriate approach to the company's trade creditors. If the company's financial condition permits the continued payment of trade debt consistent with its terms, a communications program similar to that designed for the company's employees may be used. The campaign should provide trade creditors with basic information concerning the company's predicament, while at the same time emphasizing that the company's operations in general and its trade obligations in particular will be unaffected. The adequacy of the company's cash flow and its desire to leave trade creditors unimpaired should be underscored. If the company's financial problems are more serious and the company's trade creditors are likely to be affected, a more aggressive program will be required. If such is the case, the company should deal with its major trade creditors in much the same way as it handles its lenders.

[c] Communication With Customers.

The level of sophistication of a troubled company's customers will depend on the nature of the company's business. If the company's business is consumer oriented--retailing, for instance--the company's customers will generally be small and unsophisticated. In other instances, such as the manufacture of heavy equipment, the company's customers may be just as sophisticated as its lenders. In both cases, however, the customers' focus will be the same. Does the company remain a reliable source of goods and services? To respond to this concern, the company must try to assure its customers of its stability over the short-term and its viability over the long-term. When possible, the employees who deal regularly with the company's customers should be trained to deliver this message.

[3] Due Diligence.

Simultaneously with the troubled company's initial contacts with its various constituencies, members of the restructuring team should be performing a due diligence on the company. This investigation must have both a legal and financial component.

[a] Legal Due Diligence.**[i] Scope of Investigation.**

The scope of counsel's legal due diligence will depend on the extent of restructuring counsel's prior familiarity with the troubled company. Counsel that prior to the restructuring served as the company's general counsel may already be acquainted with the information relevant to the due diligence. However, if restructuring counsel had no prior dealings with the company, the scope of the investigation will be broad. Whether as the result of prior experience or of investigation, by the end of the legal due diligence counsel should be familiar with all facets of the troubled company's legal existence.

[A] Organizational Structure.

Counsel must understand the details of the company's organizational structure. All members of the corporate group must be identified and their relationships charted. The organizational documents (*i.e.*, charter and by-laws) of each member of the corporate group should be obtained and reviewed.

[B] Intercompany Transactions.

Counsel must become familiar with all intercompany relationships. The company's financial officers must be interviewed concerning the group's cash management system. Is there a consolidated cash management system? At what level are collections and disbursements consolidated? What types of accounts are maintained at the subsidiary level? A current accounting of all intercompany accounts must be obtained. The company's officers must be interviewed concerning all other material intercompany transactions, including intercompany guarantees, tax sharing arrangements and agreements allocating overhead and other expenses.

[C] Debt Agreements.

Counsel must obtain and review all material debt agreements to which the company is party, including all loan agreements, trust indentures, note purchase agreements and other debt agreements, and all related documentation (including mortgages, deeds of trust, security agreements, pledge agreements and intercreditor agreements).

[D] Other Material Agreements.

Counsel must also obtain and review the other material agreements to which the company is party. All material leases, employee benefit plans, directors' and officers' insurance policies, collective bargaining agreements and supply and purchase contracts should be analyzed.

[E] Material Transactions.

Through interviews with knowledgeable employees and review of available documentation,ⁿ² counsel should become familiar with all recent material transactions. These include any major corporate reorganizations or restructurings (including leveraged buyouts and recapitalizations),ⁿ³ any material divestitures or acquisitions, any material payments during the preceding year, any grant of substantial collateral during the preceding year, any significant transactions involving insiders and any major lawsuits.

[ii] Focus of Investigation.

The primary purpose of the legal due diligence is to familiarize restructuring counsel with the details of the troubled company's legal life. However, in performing legal due diligence on a troubled company, counsel should also seek to assess the company's position as it enters the restructuring. This involves ascertaining the answers to several questions.

[A] What Problems Confront the Troubled Company?

Counsel to the troubled company must determine which major issues the company is likely to confront in the restructuring. Many of these issues will be readily apparent. The company may have operational problems that must be fixed. Inevitably, the company's capital structure will require modification. Debt must be converted into equity. Payment terms must be modified to reduce the company's debt service obligations.

However, the troubled company will frequently suffer from less obvious, but equally serious, maladies. Excessive labor costs may be dictated by a collective bargaining agreement that will have to be renegotiated in the restructuring. An underfunded pension plan may require negotiation with the Pension Benefit Guaranty Corporation or the Internal Revenue Service concerning minimum funding requirements or termination of the plan.ⁿ⁴ If a portion of the company's equity securities are held by an employee stock ownership trust, the Department of Labor may investigate the trust's acquisition of the securities or seek to review the percentage of the company's restructured equity securities allocated to the trust in the workout. The workout may have to be structured so as to avoid substantial taxable income or to preserve valuable tax attributes.ⁿ⁵ The troubled company may have substantial lease or contractual obligations that must be modified in the restructuring. Resolution of these problems may be as essential to the success of the restructuring as renegotiation of the troubled company's financing arrangements. As a result, it is crucial that counsel identify these issues early in the restructuring process and begin immediately to formulate a plan for resolving them.

[B] What Are the Restrictions to Which the Troubled Company Is Subject?

The restructuring takes place against the backdrop of the troubled company's legal and contractual obligations. The company's dealings with certain of its constituencies are governed by statute. The securities laws structure the company's communications with its public security holders. The laws relating to employee benefit plans regulate the company's dealings with the beneficiaries of these plans, while the company's relationships with other constituencies are controlled by contract. For instance, a company's debt agreements typically restrict its ability to engage in various transactions outside of the ordinary course of business.

The identification of the restrictions imposed by statute and by contract is an important goal of counsel's legal due diligence. May the company incur additional indebtedness? If so, under what conditions? Does the company require the consent of its lenders to sell assets? Must the proceeds of an asset sale be used to prepay lenders? May the company grant collateral to an unsecured creditor? May burdensome contracts and leases be terminated on short notice? May valuable contracts and leases be assigned? The restructuring will require extraordinary action by the troubled company, and the company must know under what conditions various actions may be taken.

In addition, counsel must seek to identify any restrictions the troubled company has already breached. Has the company exceeded any of the financial ratios imposed by its debt agreements? Has the company failed to make any required payments under debt agreements, contracts or leases? If the company has breached one of its obligations, counsel must identify the consequences. In the case of a contracts and leases, may the other party terminate the agreement? In the case of a debt agreement, what percentage in principal amount of the debt held by the lenders party to the agreement is required to accelerate? May they do so immediately or does the relevant debt agreement provide for a grace period? If the lender chooses not to accelerate, will the breach violate other debt agreements due to cross-default provisions? Will a default occur under other debt agreements if the lender accelerates? Finally, when a default has occurred and action by the relevant lender may be impending, counsel must determine if and how this action might be forestalled. Is the default

under a private or public debt agreement? What percentage in principal amount of the debt held by the lenders party to the defaulted agreement must agree to any waiver or modification?

Unless these issues are resolved, counsel will not be able to advise the troubled company intelligently. The answers to these questions will be central to many of the company's decisions during the restructuring. The company will not be able to structure the workout unless it understands the limitations on its behavior. The company will not be able to identify the parties with which it must communicate unless it understands the obligations on which it may shortly be in default. It will not be able to time or focus its discussions with its lenders properly unless it is aware of when and how defaults may be cured.

[C] What Tools Are Available to the Troubled Company?

In conducting its legal due diligence, counsel should also seek to identify the troubled company's strengths. Other parties to the restructuring may suffer from vulnerabilities. If these vulnerabilities are identified and properly analyzed, they can be exploited by the company in restructuring negotiations.⁶

The position of the company's senior secured lenders may appear to be impregnable. However, investigation sometimes reveals weaknesses. Have all of the financing statements required by the Uniform Commercial Code been filed? Are they in the proper form and have they been filed in the appropriate locations? What is the value of the lender's collateral relative to the amount of its debt outstanding?

Unsecured lenders may also be vulnerable to attack. Recent payments and grants of collateral may be voided as preferences. Upstream and cross-guarantees may be attacked as fraudulent transfers. If the loan was made to finance a leveraged buyout, recapitalization or other leveraged transaction, the entire obligation may be subject to avoidance as a fraudulent transfer.

[b] Financial Due Diligence.

While counsel is conducting its legal due diligence, the restructuring team must also conduct a financial due diligence. Broadly speaking, the goal of this investigation is to identify both the short-term and long-term financial and operational problems confronting the troubled company and to decide what corrective action is required. This financial due diligence is primarily the province of the company's other advisors, such as the accountants, financial advisor and crisis manager. However, counsel must become familiar with these advisors' findings. Is the company's cash position dangerously low? Will additional financing be required? Must this additional financing take a particular form--letters of credit, for instance--which can be provided only by a financial institution, or can the additional financing be generated internally, through cost cutting, asset dispositions and the like? Must segments of the company's business be discontinued? Are there marketable assets that can be sold without damaging the core business? The answers to these and the other questions asked in the financial due diligence will be central to the planning process.

[4] Initiating the Planning Process.

The last and most important step in the initial stage of the workout is the commencement of the planning process. The planning process involves two basic components: preparation of a short-term, interim plan and development of a comprehensive, long-term plan.

[a] Short-Term Planning.

The primary focus of the short-term planning process is the stabilization of the troubled company. The restructuring team must respond to the company's most pressing problems in order to keep the company alive while a comprehensive, long-term plan is developed. Typically, the short-term plan involves two elements: a financial component and a legal component.

[i] Stabilizing Cash Flow.

From a short-term perspective, the most pressing financial problem facing the troubled company will usually be its cash flow. In many cases, the company's financial distress is in significant part the result of negative cash flow. The company's debt service obligations may, for instance, exceed the income generated by the company's operations. Even when insufficient liquidity is not a cause of the company's financial distress, the company's other problems may damage its cash flow over time. For example, news of the company's troubles may cause a reduction in sales volume, a loss of short-term financing or a tightening of trade credit. Any one of these could turn the company's cash flow negative. If a restructuring is to succeed, the restructuring team must act quickly to stem the outflow of cash. If cash flow remains negative, the period of time available to the company for implementation of a restructuring will be very short. Furthermore, continued negative cash flow will rapidly erode management's credibility with the company's constituencies.

Initially, the restructuring team's efforts to control cash flow should focus on obtaining an accurate picture of the company's cash position. Frequently, the company's financial distress will be the result in part of inadequate reporting. The company's management will lack a clear idea of the amount of cash on hand at any particular time. Further, even when the company's reporting is satisfactory, the company's reporting systems may not have been designed to provide information in the form and with the frequency required by the restructuring team. Consequently, the restructuring team must work quickly to understand the troubled company's method of determining its cash on hand and correct any inadequacies.

Once this has been accomplished, the restructuring team must turn its attention to projecting the company's near-term cash flow. For most troubled companies, this will be a new exercise. Even if the company had previously prepared budgets, these were most likely done on a monthly, quarterly or annual basis. Given the many pressures on a troubled company's cash flow and the importance of adequate cash flow to the restructuring process, the company must project its cash sources and uses on a week-by-week basis. Only by doing so will the restructuring team be able to identify potential shortages in time to take appropriate countermeasures.

Once potential problems have been identified, the restructuring team must take the necessary steps to manage the company's cash position appropriately. In some instances, the solution will be obvious. If the company is generating cash on an operating basis but its debt service obligations exceed operating cash flow, the company must reduce its debt service. However, if the company is losing cash on an operating basis, a more complex approach will be required. Attention must be paid to both sources and uses of cash. On the revenue side of the equation, the restructuring team should consider such measures as managing receivable collections more aggressively, consolidating the company's cash accounts so as to eliminate imprest balances, factoring notes receivable and selling excess plant and equipment. On the expense side of the equation, the restructuring team should consider managing accounts payable and cutting expenses. The appropriate combination of remedies will depend on the company in question and its particular problems.

[ii] Negotiating a Standstill.

The workout negotiation will take place during a period when many, if not all, of the troubled company's creditors have the right to accelerate their debt. Consequently, while some members of the restructuring team are seeking to adjust the company's cash flow so as to gain a measure of financial breathing room, other members of the restructuring team (including, in particular, counsel) should be endeavoring to win a similar period of respite from the company's creditors.

In this undertaking, the restructuring team must first decide whether to seek to formalize this period of grace or "standstill." A formal standstill may take a variety of forms. It may be as simple as a letter waiving certain defaults or as complicated as an override agreement that substitutes new covenants, events of default and other provisions for the terms of the troubled company's existing debt agreements. At a minimum, a formal standstill requires a written undertaking by certain of the troubled company's creditors not to act on identified existing and potential defaults for a

specific period of time. The alternative to a formal standstill is, of course, an informal standstill. This rubric also covers a variety of arrangements, ranging from unilateral action by the troubled company to an explicit, but unwritten, agreement between the troubled company and certain of its creditors.

Selection of the proper approach depends on a number of variables and is often complex. A formal standstill offers the troubled company certainty. It provides the company with an enforceable, contractual commitment by its creditors not to exercise their remedies. In addition, when it includes a waiver of existing events of default, it may permit the troubled company to avoid cross-defaulting other debt agreements with which it is otherwise in compliance. These advantages, however, are obtained at a cost. First, the formal standstill takes time to negotiate and implement, and time is often an invaluable commodity for a company in financial distress. Furthermore, the price demanded by the company's creditors in return for a formal standstill will often exceed the price of an informal standstill. Finally, in some cases a formal standstill is simply not a practical possibility. If the troubled company is in default on its obligations to holders of public debt securities, the holders may be too numerous to permit the company to win the consents necessary for a formal standstill.

Once the restructuring team has decided on the approach it wishes to take, it must determine the terms it will seek. The provisions required by the troubled company will usually be obvious. The company will probably have breached certain of its covenant obligations and may be on the verge of defaulting on others. These defaults must be waived or, alternatively, the lenders must agree not to accelerate or exercise remedies on the basis of these defaults. In addition, the company may require a reduction in its debt service obligations. Any principal payments coming due will probably have to be deferred. Interest payments may also require adjustment. In some cases, the troubled company will simply agree to pay its lenders all cash flow in excess of a specified amount required to operate the company's business. Finally, the length of the standstill should permit the company a reasonable period of time to initiate the restructuring negotiations. A period of several months is usually sought.

The more complex problem facing the restructuring team is determining the price the troubled company is prepared to pay for these concessions. The company's lenders will invariably seek a broad range of concessions in return for a standstill. Many of these demands, including more frequent debt service payments and enhanced reporting requirements, are relatively innocuous. However, substantial and difficult negotiation often occurs over two issues.

First, if the company's lenders are unsecured or undersecured, they will usually seek collateral for their claims. The troubled company should generally resist this request strenuously. By allocating all or a significant portion of the company's unencumbered assets to specific creditors, this grant may impair the company's relationships with its other creditors, including in particular its trade creditors. In addition, by improving the position of the creditors party to the standstill, the grant of collateral may reduce their level of apprehension concerning a bankruptcy and, consequently, their flexibility in the workout negotiations. Moreover, if bankruptcy ultimately ensues in spite of the workout, the company's flexibility in obtaining postpetition financing or proposing a plan of reorganization may be restricted because of the protections afforded by the Bankruptcy Code to secured creditors.

Second, efforts by the troubled company's creditors to tighten covenants and events of default in order to permit close monitoring of the company's condition raise important issues for the company. If the company has made substantial concessions to win a period of respite--including, in particular, when it has granted significant collateral--the company may be justifiably concerned that excessively restrictive covenants and events of default will render the period of grace illusory. In such cases, the company should seek terms that permit a measure of further deterioration in the company's affairs without terminating the standstill.ⁿ⁷

[b] Long-Term Planning.

The restructuring team must also initiate the long-term planning process early in the workout. At this stage of the restructuring, information central to the process may be sketchy or unavailable. In addition, more pressing, near-term

problems may distract the restructuring team from the task. It is essential, however, that the long-term planning process begin at as early a stage as possible. Evidence of this effort may play a significant role in instilling confidence in the troubled company's management among its constituencies. Furthermore, without some sense of the company's long-term direction, inappropriate short-term planning decisions may be made.

[i] Development of the Business Plan.

The central element of the long-term planning process is the development of a business plan for the company. The business plan is in effect the company's case for a restructuring. It will describe for the company's various constituencies how the operating business will be reconfigured so as to improve results and attempt to project the enhanced results that will be produced. In so doing, the business plan should demonstrate to these constituencies that with time and other concessions the troubled company will be in a position to generate more value than would be produced by other alternatives, including a liquidation.

The first step in production of the business plan is the identification of the inadequacies of the company's operations. Every aspect of the operating business should be reexamined. Do all of the company's lines of business make strategic sense? Are all of the company's operating units profitable or potentially so? Are otherwise healthy lines of business or operating units being hindered by other problems such as inadequate management or excessive cost levels? Existing management may be reluctant to engage in a truly comprehensive review since it will require a reexamination of past decisions and long-standing attitudes. The restructuring team, and in particular the company's outside advisors, must encourage management to overcome these inhibitions. Unless the company's constituencies are convinced that the planning process was conducted with an open mind, they will not be persuaded by the business plan and its conclusions.

Once the company and the restructuring team have identified the company's operating problems, they must devise a cure. This is likely to be the most difficult and controversial stage of the planning process. Management and the restructuring team will be forced to consider a range of proposals many of which will call for drastic action. Should the company abandon certain lines of business? Should the company downsize, closing a significant portion of its operating units? Must personnel be replaced? Must costs be substantially reduced? Many of these steps are likely to be highly unpopular internally. Once again, however, proper conduct of this analysis will be crucial to the creditability of management and the business plan it produces. Under the best of circumstances, many of the decisions made by management will be controversial with creditors and other constituencies. By virtue of their position, creditors are inclined to view such issues as the appropriate level of capital expenditures and the scope of necessary asset sales differently than management. If management does not confront these issues in a hard-headed manner, the gap between the business plan and the expectations of creditors may be unbridgeable.

Once the company and the restructuring team have identified the company's operating problems and the appropriate countermeasures, they must create a picture of what the reconfigured business will look like. This picture takes the form of financial projections that predict the operating income that will be generated by the reconfigured business during the years immediately following the restructuring. In so doing, the projections provide the foundation upon which the second component of the long-term planning process--the development of a restructuring plan--is built.

[ii] Development of the Restructuring Plan.

In formulating the business plan, the focus of the troubled company and the restructuring team is on the company's operations. During development of the restructuring plan, attention shifts to the company's capital structure. Broadly speaking, the restructuring plan seeks to answer two questions. What form will the value predicted by the financial projections contained in the business plan take, and how should this value be allocated among the company's constituencies?

By predicting the financial performance of the troubled company's reconfigured business over a period of time, the

business plan identifies a fund available for distribution to the company's creditors and equity security holders. However, this fund, often referred to as the company's "enterprise value," is not all available for distribution in cash at closing of the restructuring. A portion of the value may take this form. If the company has ceased making debt service payments, it may be building cash. The business plan may call for the immediate sale of certain assets, generating additional cash. However, the portion of the enterprise value available in cash at closing is likely to be small. Most of the value will take the form of operating income to be generated in future years. Further, much of this operating income will not be generated in the near term. In fact, if the business plan calls for dramatic changes to the company's operations, it is likely that these changes may take several years to implement fully and that a very small portion of the projected operating income will be produced in the years immediately following the restructuring.

The allocation of enterprise value between immediately available cash and future income and the period over which the future income will be generated will determine the form in which the enterprise value of the troubled company can be allocated to its creditors and equity security holders in the restructuring plan. The portion of the cash that is not required for working capital and other near-term expenditures can be distributed as payment of accrued and unpaid liabilities at closing of the restructuring. The portion of the value reflecting operating income during the years immediately following the restructuring can be distributed in the form of debt securities with debt service requirements consistent with the projected level of income. The remainder of the value can be distributed in the form of equity securities.

Having determined the company's enterprise value and the form in which it can be distributed, the restructuring team must consider whether steps should be taken to alter the mix. As already indicated, most of the value will usually take the form of debt and equity securities. However, certain of the company's creditors--the holders of its public debt securities, in particular--may place a high value on liquidity and, consequently, seek a distribution that can be readily turned into cash. The troubled company can facilitate this in a variety of ways. The least controversial of these is usually the registration of the securities to be issued in the restructuring for sale to the public and the listing of the securities on a national exchange. These steps are designed to create a liquid public market into which creditors and equity security holders may sell the securities they receive in the restructuring. In many cases, however, this is not a viable option. The securities may not be suitable for public trading because of the size of the issue or the nature of the issuer.

Even when these obstacles are not present, the company's creditors and equity security holders may fear that trading in the securities subsequent to the restructuring will be so limited as a result of the company's financial condition that sale into the market will not produce an acceptable price. In such instances, the troubled company may be forced to consider other, more drastic alternatives. For example, it may be possible to sell a substantial asset or line of business. Alternatively, it may be possible to find an investor who is prepared to inject a significant amount of money into the company in return for a substantial equity stake. These steps will significantly increase the pool of cash available for distribution to creditors and equity security holders. However, this liquidity is only obtained at a price that the restructuring team and the committees negotiating on behalf of the company's various constituencies must carefully weigh. Most important, this liquidity may only be achievable if the company provides the outside investor with a significant discount from the projected value of the assets or securities being purchased.

The final stage in the development of the restructuring plan is the allocation of enterprise value among the troubled company's creditors and equity security holders. At this stage, the restructuring team must take into account a wide range of factors, including the size of claims, their degree of contingency and, if available, their market value. However, the primary focus should be on the relative position of the company's various creditors and equity security holders. The enterprise value must be allocated with an eye to both the legal rights and priorities to which each creditor and equity security holder is ostensibly entitled and any vulnerabilities that might cause an adjustment in these rights and priorities.

This does not mean, however, that value will be allocated in absolute order of priorities with the most senior claimants receiving payment in full before junior claimants receive any distribution. Certain groups of claimants are often prepared to sacrifice economic value in the pursuit of other goals. As already discussed, holders of public debt securities will on occasion trade value for liquidity. Institutional lenders are frequently focused on accounting concerns and may

be prepared to make concessions in return for a restructuring that will permit them to keep the loan on their books on a performing basis.

Finally, a workout is by definition a consensual arrangement. The consent of junior claimants will not be forthcoming unless they are offered something more than they are entitled to on the bases of their legal rights. Senior claimants will generally be prepared to accept something less than they have a right to receive in order to avoid the expense, delay and disruption of a bankruptcy. Finding a level of concessions acceptable to each constituency will be a key to devising a successful restructuring plan.

FOOTNOTES:

(n1)Footnote 1. See *PP 5.04 and 5.05 infra* for a discussion of some of the issues peculiar to initiating contacts with holders of public debt securities.

(n2)Footnote 2. Useful sources of information include the company's most recent financial statements, prospectuses prepared in connection with any recent public offerings and the company's filings on Form 8-K, Form 10-Q and Form 10-K.

(n3)Footnote 3. The relevant period of time will depend on the applicable statute of limitations for fraudulent conveyance actions. Under the Bankruptcy Code, in a case commenced on or after April 21, 2006, actions may be brought with respect to a transaction occurring within two years preceding the filing of the petition for relief (one year if the case is commenced before April 21, 2006). However, *section 544(b) of the Bankruptcy Code* allows a debtor or bankruptcy trustee to avail itself of otherwise applicable state law limitations periods, which often are substantially longer. The Uniform Fraudulent Transfer Act, which has been adopted in many states, provides for a four-year statute of limitations in many instances. See *Unif. Fraudulent Transfer Act* § 9(a), (b), 7A U.L.A. 665 (West 1985). In New York, the applicable statute of limitations is six years. *N.Y. C.P.L.R. 213(8)* (2005); see *Orr v. Kinderhill Corp.*, 991 F.2d 31, 34-35 (2d Cir. 1993) ; *Fromer v. Yogel*, 50 F. Supp. 2d 227, 245 (S.D.N.Y. 1999) ; *In re Garcia Avila*, 296 B.R. 95, 113 n.25 (Bankr. S.D.N.Y. 2003) .

(n4)Footnote 4. An underfunded pension plan may give rise to a variety of problems that must be dealt with in the restructuring. First, plans subject to the Employee Retirement Income Security Act of 1974 (as amended, "ERISA") must comply with minimum funding standards. These standards require annual contributions to the plan by the contributing sponsor to eliminate any accumulated funding deficiency. See *ERISA* §§ 301-308, 29 U.S.C. §§ 1081-1086 (*ERISA* § 308, 29 U.S.C. 1086 has been repealed with respect to plan years after 2007). When the company's resources do not permit payment of these contributions, it may be necessary to obtain a waiver from the Internal Revenue Service. *ERISA* § 303, 29 U.S.C. § 1083. A waiver will allow the company to stretch payment of the required contribution over a five-year period (15-year period in the case of a multiemployer plan). *ERISA* § 302(b)(2)(C), 29 U.S.C. § 1082(b)(2)(C). The Internal Revenue Service may require the company to provide security to the pension plan as a condition for granting the waiver. *ERISA* § 302(c), 29 U.S.C. § 1082(c)(4), (c). In addition, plans subject to ERISA may be terminated involuntarily by the Pension Benefit Guaranty Corporation (the "PBGC") under certain conditions. The PBGC must institute termination proceedings if it determines that the plan does not have assets available to pay benefits currently due. *ERISA* § 4042(a), 29 U.S.C. § 1342(a). The PBGC may institute proceedings in a variety of other circumstances, including when the plan has not met minimum funding standards and where the possible long-run loss of the PBGC may reasonably be expected to increase unreasonably if the plan is not terminated. *Id.* A termination gives rise to termination liability. The contributing sponsor and members of its controlled group are jointly and severally liable to the PBGC for the total amount of unfunded benefit liabilities and to the successor plan trustee for all delinquent or waived contributions. *ERISA* § 4062, 29 U.S.C. § 1362. These amounts are due and payable as of the termination date and the PBGC is granted a lien in the property of the contributing sponsor to the extent of 30% of the net worth of the controlled group if not paid. *ERISA* § 4068, 29 U.S.C. § 1368.

(n5)Footnote 5. See ch. 8 *infra* for a discussion of tax issues raised in an out-of-court restructuring.

(n6)Footnote 6. *See generally* ch. 4 *infra*.

(n7)Footnote 7. The troubled company should recognize that negotiations with its creditors over the terms of the standstill may also give rise to various intercreditor issues. If there are different lender groups, there may be arguments over the size and nature of the creditor vote required to accelerate. If a bank lender has significant rights of setoff, non-bank lenders may require that the benefits of these rights be shared. The troubled company must be sensitive to these issues because they may implicate its interests, particularly if debate becomes heated and the issues threaten to delay negotiation of the standstill.



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CHAPTER 2 Initiating the Workout

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CHAPTER 2 Initiating the Workout

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CHAPTER 3 The Board of Directors in a Workout

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CHAPTER 3 The Board of Directors in a Workout

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P 3.01 Scope and Use of This Chapter.

In today's legal environment, a director of a corporation assumes a role that is not without personal risk. Nonetheless, in a healthy company, the legal terrain facing a board of directors is relatively well charted, legal guidance is not difficult to obtain and directors' and officers' liability insurance, although expensive, is generally available. However, if the company becomes financially distressed, its directors may find themselves suddenly faced with legal problems in a new context. The once familiar terrain has assumed a much different geography, novel and difficult legal issues loom and insurance protection may evaporate.

Directors and their counsel are increasingly concerned with the nature of the fiduciary duties of directors of corporations in workouts. Directors of struggling companies may have difficulty choosing a course of action that will minimize the risk of personal liability to creditors and shareholders in the lawsuits that are likely to follow if the workout fails. In part, this is due to the lack of clear legal guidelines.

The legal framework for the duties of the board in situations in which a company is clearly solvent or insolvent is relatively straightforward. The directors of a healthy corporation owe fiduciary duties to the corporation's shareholders,ⁿ¹ and not to its creditors.ⁿ² When a company is insolvent, most courts hold that the board's primary duty shifts from the shareholders to the company itself, on behalf of which creditors may bring derivative actions.ⁿ³ In the most extreme case of an insolvent company which is so hopelessly troubled that it has no real chance of being revitalized through a restructuring, the directors must act conservatively by preserving the value of the remaining assets for the benefit of the company's creditors.

Unfortunately, these broad principles do not give real guidance to directors in workout situations where the company's solvency is unclear or where the board believes that, despite current financial problems, the company can be restructured and provide greater value to all constituents in the future. In such a situation, how can the board balance the interests of creditors and shareholders? The board is confronted with two opposing forces. On the one hand, in most restructurings, the various concessions made by creditors are critical to saving the company. It is therefore difficult to justify to creditors actions taken to achieve a recovery for shareholders at the possible expense of creditors. On the other hand, shareholders are the natural constituency of the directors and, in most restructurings, share to some degree in the ownership of the restructured company.

Case law to date does not provide clear guidance to directors of companies of doubtful solvency or companies

contemplating or negotiating a workout. For the most part, judicial decisions have failed to answer three important questions:

- How should directors define solvency and value the corporate enterprise to determine when their fiduciary duties shift?
- How should the directors of an insolvent corporation in a workout resolve conflicts between creditors and shareholders over business decisions?
- May the directors of an insolvent corporation negotiate forcefully on behalf of the shareholders without violating a duty of loyalty to creditors?

Only the third question has recently begun to receive clear treatment in case law.ⁿ⁴

This chapter seeks to guide directors (and their counsel) in fulfilling their fiduciary duties in a workout. The chapter first discusses situations in which the case law gives clear guidelines-- *i.e.*, the fiduciary duties of directors to shareholders of solvent corporations and the fiduciary duties of directors to creditors of failing companies that are clearly insolvent.

The second part of the chapter analyzes an area of the law that is less clear: the fiduciary duties of directors when negotiating a workout. Some of the uncertainty is rooted in the problem of defining "insolvency" itself. The definition used, often that of a "going concern," and the application of that definition, may determine the scope of the directors' fiduciary duties. If there is a reasonable chance of revitalizing an insolvent company through a restructuring, it should usually be valued as a going concern. In at least that case, even though the directors have determined that the company is insolvent, they need not accede to every demand made by creditors regarding business decisions, so long as the underlying business is viable and they reasonably believe that the company can be saved through a workout. The directors may negotiate the terms of the workout on behalf of the shareholders, provided that the directors treat the company's survival as paramount to the shareholders' interest in preserving their equity ownership.

The last part of this chapter discusses the use of indemnification and liability insurance to shield directors (and officers) against personal liability. It then examines how these methods of protection may be affected by the filing of a bankruptcy petition.

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986) ; *Aronson v. Lewis*, 473 A.2d 805, 811 (Del. 1984) , *overruled in part by Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) .

(n2)Footnote 2. *See, e.g., United States v. Jolly*, 102 F.3d 46, 48 (2d Cir. 1996) ; *Metro. Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) ; *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988) .

(n3)Footnote 3. *See N. Am. Catholic Ed. Programming Found. v. Gheewalla*, 930 A.2d 92, 101-03 (Del. 2007) (holding that creditors of a company that is either insolvent or in the zone of insolvency have no right to bring direct claims against the corporation's directors for breach of fiduciary duty, but noting that, once actually insolvent, creditors might bring *derivative* actions in the same manner as might shareholders of a solvent corporation against directors). *Gheewalla* punctuated an interval of extension, then retraction, of more direct and open vulnerability of corporate directors to creditors' attacks. *See P 3.03 infra*; *see generally* Dianne F. Coffino & Charles H. Jeanfreau, *Delaware Hits the Brakes: The Effect of Gheewalla and Trenwick on Creditor Claims*, 17 J. Bankr. L. & Prac. 1 art. 3 (2009). *Gheewalla* leaves open the possibility that directors may be subject to *derivative* claims by creditors in the zone of insolvency, but that is unlikely. *E.g.* E. Norman Veasey, "Counseling the Board of Directors of a Delaware Corporation in Distress," ABI Journal, Vol. 27, No. 5 (June 2008) (the former Chief Justice of the Delaware Supreme Court writing that it is "doubtful as a practical matter" that directors would under current law be liable for derivative claims brought by

creditors in the zone of insolvency or otherwise outside actual insolvency).

(n4)Footnote 4. *See Gheewalla, 930 A.2d at 103* (stating that "[d]irectors of insolvent corporations must retain the freedom to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation").



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CHAPTER 3 The Board of Directors in a Workout

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P 3.02 Fiduciary Duties of Directors of Solvent Corporations.

[1] Directors of Solvent Corporations as Fiduciaries of the Shareholders.

[a] Generally.

One of the foundations of corporate law is that the business and affairs of a corporation are managed by or under the direction of its board.ⁿ¹ This power carries with it certain fundamental duties to the corporation and its shareholders.ⁿ²

The directors owe fiduciary duties to the shareholders because property has been entrusted to the directors to be managed for the shareholders' benefit.ⁿ³ Before a fiduciary duty arises in favor of a person, that person must have an existing right or equitable interest in the property entrusted to the fiduciary.ⁿ⁴ The shareholders of a solvent corporation, in contrast to its creditors, have an equitable interest in the property of the corporation in that they have a residual interest in the assets that would be distributed upon the corporation's dissolution.ⁿ⁵ The directors, as representatives of the shareholders, are charged with running the business for the shareholders' benefit and maximizing the value of the shareholders' residual interest.

[b] Duty of Care.

A director has two basic duties: a duty to act with care in fulfilling his or her responsibilities and a duty of loyalty to the company and its shareholders.ⁿ⁶ The duty of care requires that directors exercise the care that an ordinarily prudent person would exercise in similar circumstances.ⁿ⁷ A director should act on the basis of adequate information, attend board meetings and have a general knowledge of the company's financial condition and management.ⁿ⁸ "In short, a director's decision must be an informed one."ⁿ⁹ Consistent with the duty of care, directors may delegate operational responsibilities to officers and managers. Similarly, directors may rely on information provided to them by officers and experts.ⁿ¹⁰

The business judgment rule creates a presumption in favor of the directors that they have acted with due care.ⁿ¹¹ Because the presumption is difficult to overcome, even if a director fails to comply with the "ordinarily prudent person" standard of due care, he or she will generally not be personally liable for breach of fiduciary duty unless he or she is grossly negligent.ⁿ¹² Although the precise formulation of the standard for overcoming the business judgment rule and imposing personal liability varies according to the jurisdiction, it generally requires something more than ordinary negligence.ⁿ¹³

[c] Duty of Loyalty.

The duty of loyalty requires that a director act with undivided and unqualified loyalty to the corporation and its shareholders. A director may not derive any personal advantage or confer a benefit on a third party at the expense of the corporation and its shareholders.ⁿ¹⁴ If a corporation is not insolvent, directors may breach their duty of loyalty by favoring the interests of another party over the interests of the shareholders.ⁿ¹⁵ Many courts, notably the Supreme Court of Delaware, generally interpret the duty of loyalty broadly, allowing for many permutations of claims asserting breaches of the duty of loyalty.ⁿ¹⁶

Many states passed "expanded constituency" statutes during the 1980s to assist corporations in their takeover defenses.ⁿ¹⁷ These statutes permit directors who are weighing a takeover bid to take into account, without violating their duty of loyalty, the interests of non-shareholder constituencies, including creditors, employees, suppliers, customers and the local community. Because most of these statutes permit, but do not require, the directors to consider non-shareholders, and because some of the statutes contemplate consideration of other constituencies only as a factor in determining the best interests of the shareholders,ⁿ¹⁸ it is unlikely that most of these statutes create any new fiduciary duties.ⁿ¹⁹

[2] No Fiduciary Duty Owed to Creditors of Solvent Corporations.

Unlike shareholders, creditors of solvent corporations are not owed fiduciary duties by the directors.ⁿ²⁰ Creditors of solvent corporations have the right to be paid the amount they are owed; no matter how well the corporation does, they will never be paid more than that amount. Therefore, the worth of a solvent corporation is of no direct concern to the creditors as long as solvency is maintained. Because none of the benefits of an increase in value of the corporate assets will accrue directly to the creditors, the creditors have no equitable interest in the corporate property and thus are not owed any fiduciary duty by the corporation's directors.ⁿ²¹

Moreover, a creditor's contract is between the creditor and the corporation, not between the creditor and the directors.ⁿ²² Creditors of solvent corporations have no legal relationship to the corporation's directors at all; they are "utter strangers to the obligations of the directors to the corporation."ⁿ²³

The principle that directors of solvent corporations do not owe creditors extra-contractual duties was demonstrated in *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*ⁿ²⁴ In *Metropolitan*, certain long-term debt holders of RJR Nabisco claimed that the corporation--by taking on massive amounts of additional debt in a leveraged buyout--had breached a duty of loyalty to the debtholders by not maintaining the investment-grade credit rank of their debt securities. The court rejected the bondholders' claim of breach of fiduciary duty stating that "[a] bondholder ... 'acquires no equitable interest, and remains a creditor of the corporation whose interests are protected by the contractual terms of the indenture.'" ⁿ²⁵

Although the market value of publicly traded debt is directly related to the value of the corporate assets, this benefit to creditors is incidental to their legal rights. Directors may not take action to increase the market value of publicly traded debt at the expense of shareholders. For example, in *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*,ⁿ²⁶ the board attempted to thwart a hostile takeover by giving a "lock-up" option to a friendly bidder. The board claimed that it took this action in part to protect the corporation's bondholders; as part of the consideration for the "lock-up" option, the bidder committed to support the value of the bonds. However, the effect of the "lock-up" option was to discourage other bidders, thereby preventing the shareholders from receiving higher bids. The court invalidated the "lock-up" option and held that the directors had violated their duty of loyalty by favoring the bondholders over the shareholders.ⁿ²⁷

FOOTNOTES:

(n1)Footnote 1. See, e.g., *Del. Code Ann. tit. 8, § 141*.

(n2)Footnote 2. See, e.g., *Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 179 (Del. 1986) ;

Aronson v. Lewis, 473 A.2d 805, 811 (Del. 1984) , overruled in part by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) .

(n3)Footnote 3. *Simons v. Cogan*, 542 A.2d 785, 790 (Del. Ch. 1987) , *aff'd*, 549 A.2d 300 (Del. 1988) .

(n4)Footnote 4. *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988) .

(n5)Footnote 5. *See id.*

(n6)Footnote 6. E. Brodsky & M.P. Adamski, Law of Corporate Officers and Directors § 2:1 (Clark Boardman Callaghan 2003) ["Brodsky & Adamski"].

(n7)Footnote 7. *See, e.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) , overruled in part by *Brehm v. Eisner*, 746 A.2d 244 (Del. 2000) ; *Norlin Corp. v. Rooney, Pace, Inc.*, 744 F.2d 255, 264 (2d Cir. 1984) ; *N.Y. Bus. Corp. Law* § 717(a); R. C. Clark, Corporate Law § 3.4 (1986).

(n8)Footnote 8. *Brodsky & Adamski*, n.6 *supra* , § 2:13.

(n9)Footnote 9. *Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 274 (2d Cir. 1986) .

(n10)Footnote 10. *Del. Code Ann. tit. 8, § 141(e)*; *N.Y. Bus. Corp. Law* § 717(a).

(n11)Footnote 11. For business judgment rule protection five elements must be present. The directors must have (1) made a decision to act or refrain from acting (as opposed to having simply abdicated their responsibility); (2) been disinterested; (3) exercised due care; (4) acted in good faith; and (5) not abused their discretion. The rationale behind the rule has been explained on five grounds: it encourages competent individuals to become directors who might otherwise decline for fear of personal liability; it encourages directors to engage in ventures which have potential for great profit but which may entail some risk; it keeps courts from becoming enmeshed in complex corporate decision-making; it ensures that directors rather than shareholders manage corporations; and finally, the rule recognizes that unhappy shareholders can always vote the directors out of office. D. Block, S. Barton & S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers* 12-18 (Aspen 5th ed. 1998).

(n12)Footnote 12. The presumption may only be rebutted by a showing that the Board breached its fiduciary duties of good faith, loyalty, or due care. *Block*, n.11 *supra*, at 110-111 ; *see also* Dooley & Veasey, *The Role of the Board in Derivative Litigation: Delaware Law and the Current ALI Proposals Compared*, 44 *Bus. Law.* 503, 521 (1989) ("the duty of care is more aspirational than consequential"). Most states have passed statutes authorizing shareholders to adopt charter provisions limiting liability of directors. *Block*, n.11 *supra*, at 226.

(n13)Footnote 13. *Block*, n.11 *supra*, at 132-34. It is unclear whether personal liability for breach of duty of care requires an express finding of gross negligence. *See, e.g., Hanson Trust PLC v. ML SCM Acquisition, Inc.*, 781 F.2d 264, 276-77 (2d Cir. 1986) (while not expressly holding that the independent directors were grossly negligent, noting that "they [did] not appear to have pursued adequately their obligation to ensure the shareholders' fundamental right to make the 'decisions affecting [the] corporation's ultimate destiny,' as required by their duty of care" (citation omitted)); *Edelman v. Fruehauf Corp.*, 798 F.2d 882, 886 (6th Cir. 1986) (finding a breach of duty among disinterested directors who "rubber stamped" a management buyout proposal, calling such conduct "unreasonable" under Michigan law). *But see Resolution Trust Corp. v. Dean*, 854 F. Supp. 626, 635 (D. Ariz. 1994) (pursuant to Arizona law, "under the business judgment rule, defendants liability must be predicated upon concepts of gross negligence").

(n14)Footnote 14. *See Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173, 180-82 (Del. 1986) ; *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946, 953-58 (Del. 1985) .

The business judgment rule also applies to the duty of loyalty. For example, many states have passed "safe-harbor" statutes which provide that transactions between a corporation and an insider are not automatically voidable as long as

they are approved by a majority of disinterested directors. The rationale for these statutes appears to be that business judgment rule protection is appropriate for an interested director transaction where an informed majority of disinterested directors applies its business judgment in good faith to authorize the transaction. See *Block*, n.11 *supra*, at 271 ; R. Balotti & J. Finkelstein, *The Delaware Law of Corporations and Business Organizations* § 4.35 (3d ed. Supp. 2002). Although the threshold is high, the business judgment presumption is rebuttable. See, e.g., *New York Practice Guide: Business and Commercial* § 6.13[1][b] (Matthew Bender & Co. 2001). The "safe harbor" statutes require that full disclosure of the interested directors' conflicts of interest be made to the disinterested board members or the voting shareholders. See, e.g., Delaware General Corporation Law § 144 and *New York Business Corporation Law* § 713. Upon a plaintiff's *prima facie* showing that the interested parties failed to properly disclose all relevant information related to an interested transaction, the business judgment presumption disappears, and the burden shifts to the board to show that the transaction was "fair and reasonable." *New York Practice Guide* at § 6.13[6][a][i]. This "intrinsic fairness" standard considers both fair dealing and fair price:

Fair dealing includes issues of when the transaction was timed, how it was initiated, structured, negotiated, and disclosed to the directors, and how director and stockholder approval was obtained. Fair price relates to the economic considerations of the proposed transaction, including all relevant factors: assets, market value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company's stock. The test for entire fairness is not bifurcated, however, and all aspects of the issue must be examined as a whole.

Ward, Welch and Turezyn, *Folk on the Delaware General Corporation Law* § 144.9 (4th ed. 1998).

(n15)Footnote 15. *Revlon, Inc., v. MacAndrews & Forbes Holdings, Inc.*, 506 A.2d 173 (Del. 1986) .

(n16)Footnote 16. See *Cede & Co. v. Technicolor*, 634 A.2d 345, 361 (Del. 1993) . Delaware courts have established an additional "duty of candor" that requires that once directors of a corporation decide to make certain disclosures to the stockholders/creditors, they are obligated to disclose all material facts. See *Ciro, Inc. v. Gold*, 816 F. Supp. 253, 266 (D. Del. 1993) .

(n17)Footnote 17. Block & Hoff, *Duties of Directors of Distressed Corporations*, N.Y.L.J., Nov. 8, 1990, at 5.

(n18)Footnote 18. Lieberman & Bartell, *The Rise in State Anti-takeover Laws*, 23 Rev. Sec. & Comm. Reg. 149, 154 (1990).

(n19)Footnote 19. *N.Y. Bus. Corp. Law* § 717(b) explicitly states that it does not create or abrogate any duties. Connecticut's statute, however, *requires* the board to consider the interests of non-shareholders when deciding on certain major business combinations. See *Conn. Gen. Stat.* § 33-756(d).

(n20)Footnote 20. *Simons v. Cogan*, 542 A.2d 785, 790 (Del. Ch. 1987) , *aff'd*, 549 A.2d 300 (Del. 1988) . For a review of the small minority of cases suggesting that directors of solvent corporations owe some form of fiduciary duty to the corporation's creditors, see Mitchell, *The Fairness Rights of Corporate Bondholders*, 65 N.Y.U. L. Rev. 1165, 1168-69 n.11 (1990) ("Despite occasional claims to the contrary, scholars supporting expanded bondholder rights do not have a great deal of law supporting them. The cases that assert the existence of extra-contractual rights for bondholders generally are quite equivocal in doing so.").

(n21)Footnote 21. See *Kusner v. First Pennsylvania Corp.*, 395 F. Supp. 276, 281-83 (E.D. Pa. 1975) , *rev'd on other grounds*, 531 F.2d 1234 (3d Cir. 1976) ; see also *Simons v. Cogan*, 549 A.2d 300, 303 (Del. 1988) (citing *Kusner v. First Pennsylvania Corp.*, *supra* , 395 F. Supp. 276, 281) .

(n22)Footnote 22. *Hart v. Evanson*, 14 N.D. 570, 105 N.W. 942, 943 (1895) .

(n23)Footnote 23. *Hart v. Evanson*, 14 N.D. at 575, 105 N.W. at 943 .

(n24)Footnote 24. 716 F. Supp. 1504, 1524 (S.D.N.Y. 1989) .

(n25)Footnote 25. *Id.* at 1524 (S.D.N.Y. 1989) (quoting *Simons v. Cogan*, 549 A.2d 300, 304 (Del. 1988)) .

(n26)Footnote 26. 506 A.2d 173 (Del. 1986) ["Revlon"].

(n27)Footnote 27. *Revlon*, 506 A.2d 173, 182 .



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CHAPTER 3 The Board of Directors in a Workout

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P 3.03 Fiduciary Duties of Directors of Insolvent Corporations.

[1] Directors of Insolvent Corporations as Fiduciaries of the Corporation.

Although the duties of directors of a solvent corporation are owed to the corporation for the benefit of the shareholders alone, the situation changes when the corporation becomes insolvent even, perhaps, as it approaches insolvency. The cases are replete with statements such as: "when the corporation becomes insolvent, the fiduciary duty of the directors shifts from the stockholders to the creditors,"ⁿ¹ and "when a corporation becomes insolvent, ... the ... directors no longer represent the stockholders, but by the fact of insolvency, become trustees for the creditors."ⁿ² More recently, courts have refined this shorthand rule to make clear that when a corporation becomes insolvent or enters the so-called "vicinity of insolvency" or "zone of insolvency," directors' obligations remain "to the firm itself" although the ultimate beneficiaries entitled to bring derivative actions may shift from the shareholders to the creditors.ⁿ³

The rationale for this shift in fiduciary duties is simple. If a company is truly insolvent, only the creditors will receive anything on dissolution. The creditors, as residual risk bearers therefore have what may be considered an equitable interest in the corporate property.ⁿ⁴ The amount they will eventually collect is directly dependent on the value of the corporate assets. Thus, according to the now prevailing view, directors of an insolvent corporation owe fiduciary duties to the corporation's creditors just as directors of a solvent corporation owe their fiduciary duties to the corporation for the benefit of its shareholders.ⁿ⁵ Instead of trying to act solely in the shareholders' interests by maximizing the value of the remaining assets, the directors must act conservatively in the corporation's interest, and, at least when the company has no real chance of being revitalized, they must preserve for the creditors the value of the assets pending liquidation. The director's role has changed from "helmsman to guardian."ⁿ⁶

The corporation and its officers owe to their creditors this duty: not to divert the corporate property from the general purpose of paying the creditors. ... A violation of this duty will entitle the creditors who suffer thereby to relief.ⁿ⁷

If the directors of an insolvent corporation act in the shareholders' interests by taking risks in the remote hope that they can return the company to solvency, they may be acting in violation of the duty they owe to the entire corporation and, indirectly, to the creditors.ⁿ⁸ If the directors fail to fulfill their duty of loyalty by preserving the corporation's remaining assets, they may be personally liable,ⁿ⁹ either to the corporation, the creditors as a class or to a trustee or receiver on behalf of all the creditors.ⁿ¹⁰ However, even when a firm is insolvent, the directors are allowed to pursue a business strategy that maximizes value and incurs additional debt if they acted with due diligence and good faith," even if in

retrospect, that strategy had the effect of deepening insolvency.ⁿ¹¹ Moreover, the directors even of an insolvent firm are entitled "to engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation."ⁿ¹²

[2] Standard of Care Owed to Creditors.

Although the ultimate beneficiaries of directors' fiduciary duty of care shifts, or at least expands, from the shareholders to include the creditors when a company becomes insolvent, the cases do not give rise to an inference that the standard of care owed to creditors is any greater than that normally owed to shareholders: that of an ordinarily prudent person in similar circumstances.ⁿ¹³

Indeed, the cases make clear that the directors of an insolvent company are protected by the business judgment rule (or a standard similar to it).ⁿ¹⁴ For instance, in *Devereux v. Berger*,ⁿ¹⁵ a secured creditor, acting on behalf of a corporation, sued a director of that corporation for mismanagement. The court held that the business judgment rule applied, and that the director was liable only for those losses attributable to the director's gross negligence, and not those losses caused merely by bad business judgment. In *In re Xonics, Inc.*,ⁿ¹⁶ the creditors brought an action for breach of fiduciary duty against a director. In an attempt to save the company, the director had led the board in a sale of certain assets, and the transaction destroyed the company. As part of the transaction, the director was released from a personal guarantee. The court said that the director owed fiduciary obligations to the creditors the moment the company became insolvent. Nevertheless, the court concluded that the director was not personally liable, using language reminiscent of the business judgment rule:

This court must be able to rely on officers' and directors' actions, even for an insolvent corporation unless those seeking damages show that such actions are venal. To require less in assessing breach of fiduciary duty ... would constrain the commercial world in developing means to aid the floundering corporation.ⁿ¹⁷

Some commentators, have suggested that the holding in *New York Credit Men's Adjustment Bureau, Inc. v. Weiss* ⁿ¹⁸ dictates a heightened standard of care for directors of insolvent corporations.ⁿ¹⁹ In *Weiss*, the court implicitly deprived the directors of the protection of the business judgment rule by placing on them the burden of proving that they received the fair value of the corporation's assets in a liquidation auction. Had the directors chosen to liquidate the corporate assets within the available statutory framework for liquidation (*e.g.*, receivership or bankruptcy), they would have had the benefit of court oversight. The directors, however, chose to liquidate the assets on their own and, as "trustees" or "quasi-trustees," they were obligated to account for the difference between the fair value of the assets and the value actually received. This stringent duty for directors of insolvent New York corporations, if still viable, is probably limited to the context of directors liquidating the assets of a corporation outside a statutory framework.ⁿ²⁰

The use of the term "trust fund"ⁿ²¹ in *Weiss* and other cases to support the general proposition that the creditors of an insolvent corporation are owed fiduciary duties has created some confusion as to the applicable standard of care. The trust fund doctrine is not interpreted literally; the assets of an insolvent corporation are not an actual trust,ⁿ²² and the directors are not actually trustees whose conduct is governed by the very strict fiduciary standards of the law of trusts.ⁿ²³ Courts that loosely refer to directors of insolvent corporations as trustees for the corporation's creditors should not hold the directors to any standard of care higher than that owed to shareholders of solvent corporations, that of an ordinarily prudent person in similar circumstances.ⁿ²⁴

[3] Creditors' Remedies for Breach of Fiduciary Duty.

The statutes governing fraudulent conveyances, preferences and illegal dividends together with implied covenants of good faith and fair dealing and agreed contractual protections, create rights of action in creditors (or receivers or trustees acting on their behalf) for the recovery of misapplied assets of insolvent corporations.

Some of these statutes provide that creditors may sue the directors directly for negligently authorizing a transaction in violation of the statute. For instance, section 174 of the Delaware General Corporation Law imposes liability on directors for negligently authorizing an illegal dividend (*i.e.*, a dividend made while the corporation is insolvent). Even though other statutes, such as the statutes governing fraudulent conveyances (*e.g.*, the Uniform Fraudulent Conveyance Act)ⁿ²⁵ do not give creditors the express right to sue the directors who authorized the improper transaction, directorial liability may still be imposed under state corporate law theories if the directors failed to exercise due care or breached their duty of loyalty in approving the transactions.ⁿ²⁶

The courts that have adhered to the view that creditors of insolvent corporations are owed fiduciary duties allow creditors to maintain an action against the directors for mismanagement.ⁿ²⁷ Most of these courts require that the action be maintained on behalf of all creditors in order to ensure that the recovery from the directors is shared fairly among the injured creditors.ⁿ²⁸ Of course, a trustee in bankruptcy can sue the directors for mismanagement, since bankruptcy trustees may maintain any action that the corporation could have maintained.ⁿ²⁹

FOOTNOTES:

(n1)Footnote 1. *Federal Deposit Ins. Corp. v. Sea Pines Co.*, 692 F.2d 973, 976-77 (4th Cir. 1982) , *cert. denied*, 461 U.S. 928, 103 S. Ct. 2089, 77 L. Ed. 2d 299 (1983) . Some cases had held that fiduciary responsibilities to creditors may arise earlier than the point of insolvency. *See, e.g., Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, 1991 Del. Ch. LEXIS 215, *108 n.55 (Del. Ch. Dec. 30, 1991) (a corporation "in the vicinity of insolvency" must consider a "community of interests," not merely those of the shareholders). *See also Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del., Inc.)*, 280 B.R. 90, 92 (D. Del. 2002) ("it is well-established that creditors are owed fiduciary duties in the zone of insolvency"); *Dawson v. Withycombe, No. 1 CA-CV 06-0043*, 2007 WL 2108836, at *17 (Ariz. Ct. App. July 24, 2007) ("[W]hen a firm is insolvent, creditors are included in the class of persons to whom a board of directors owes a fiduciary duty."); *Miller v. Dutil (In re Total Containment, Inc.)*, 335 B.R. 589, 603 (Bankr. E.D. Pa. 2005) (same). More recent case law, however, denies that creditors are owed the fealty of directors of corporations in the zone of insolvency--that is, until insolvency itself. *E.g., North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) (stating that when "a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners").

(n2)Footnote 2. *Davis v. Woolf*, 147 F.2d 629, 633 (4th Cir. 1945) (quoting *Arnold v. Knapp*, 75 W. Va. 804, 811, 84 S.E. 895, 899 (1915)) . The concept that the assets of an insolvent corporation are a "trust fund" for the benefit of the creditors, or that the directors are "trustees" for the creditors, is known as the "trust fund" doctrine. *See, e.g., Amdura Nat'l Distrib. Co. v. Amdura Corp. (In re Amdura Corp.)*, 75 F.3d 1447, 1452 (10th Cir. 1996) ; *United States v. Van Diviner*, 822 F.2d 960, 965 (10th Cir. 1987) ; *Automatic Canteen Co. v. Wharton*, 358 F.2d 587, 590 (2d Cir. 1966) ; *Paratransit Risk Retention Group Ins. Co. v. Kamins*, 160 P.3d 307, 319-20 (Colo. Ct. App. 2007) ("Directors of an insolvent corporation are deemed to be trustees for the corporation and for its creditors."); *CarrAmerica Realty Corp. v. nVidia Corp.*, 2006 WL 2868979, at *5 (N.D. Cal. 2006) (slip opinion) ("[A]ll of the assets of a corporation, immediately on its becoming insolvent, become a trust fund for the benefit of all of its creditors.") (citations and internal quotations marks omitted). The term "trust fund," however, is not interpreted literally. *See P 3.03[2] infra*.

(n3)Footnote 3. *Adelphia Communs. Corp. v. Rigas (In re Adelphia Commc'ns Corp.)*, 323 B.R. 345, 386 n.140 (Bankr. S.D.N.Y. 2005) (quoting *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 791 (Del. Ch. 2004)) . "[T]he fact of insolvency does not change the primary object of the director's duties, which is the firm itself. The firm's insolvency simply makes the creditors the principal constituency injured by any fiduciary breaches that diminish the firm's value and logically gives them standing to pursue these claims to rectify that injury." *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 792 (Del. Ch. 2004) . However, the Delaware Supreme Court has recently clarified that creditors' standing to pursue such claims is limited to their right to bring derivative actions, but only for breaches that

occur when the corporation is actually insolvent. See *North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, No. 521, 2006, 2007 WL 1453705 (Del. May 18, 2007). For cases discussing generally the concepts of "vicinity of insolvency" and "zone of insolvency," see P 3.03[1], n.1 *supra*.

(n4)Footnote 4. See Still, *Directors' Liability, Business Judgment and a Note on Directors and Creditors*, 1990 ABA Section on Corporate, Banking & Business Law 28.

(n5)Footnote 5. P 3.01, n.3 *supra* .

(n6)Footnote 6. *In re Baldwin-United Corp.*, 11 C.B.C.2d 1391, 1412, 43 B.R. 443, 460 (S.D. Ohio 1984) .

(n7)Footnote 7. *Wilkinson v. Bauerle*, 41 N.J. Eq. 635, 645, 7 A. 514, 518 (N.J. 1886) ; see also *Wortham v. Lachman-Rose Co.*, 440 S.W.2d 351, 353 (Tex. Civ. App. 1969) ("When an insolvent corporation ceases to do business its assets are a trust fund held for the benefit of its creditors. And directors of such a corporation who fail to discharge their duty of seeing that its creditors were either paid in full or that they were paid pro rata from its assets are liable to those creditors.") (citations omitted).

(n8)Footnote 8. In *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215 (Del. Ch. Dec. 30, 1991) , the Delaware Court of Chancery explored this issue in an analysis of a hypothetical litigation settlement. See *id.* at *108, n.55 . In the proposed settlement, the expected recovery was sufficient to pay the distressed company's creditors in full, but provided little recovery to its shareholders. See *id.* Successful litigation, although risky, would result in a higher residual equity value, and a greater recovery to shareholders. See *id.* The court stated that the distressed company should not risk losing the settlement recovery in a dicey attempt to obtain a higher recovery. See *id.* Instead, the court found that the troubled company must consider a "community of interests," not merely those of the shareholders:

[I]n managing the business affairs of a solvent corporation in the vicinity of insolvency, circumstances may arise when the right (both the efficient and the fair) course to follow for the corporation may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act.

Id. at *108 n.55 .

(n9)Footnote 9. See P 3.01, n.3 *supra*; P 3.03[3] *infra*.

(n10)Footnote 10. *Id.*

(n11)Footnote 11. See *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 205 (Del. Ch. 2006) (rejecting the "deepening insolvency" theory in favor of the business judgment rule where directors of a wholly owned subsidiary allegedly acquired more debt while insolvent); see also *Official Comm. of Unsecured Creditors of Radnor Holdings Corp. v. Tennenbaum Capital Partners, L.L.C. (In re Radnor Holdings Corp.)*, 353 B.R. 820, 843 (Bankr. D. Del. 2006) ("[D]irectors of an insolvent company may pursue strategies to maximize the value of the company, including continuing to operate in the hope of turning things around.").

(n12)Footnote 12. *North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007)

(n13)Footnote 13. See e.g., *Schnelling v. Crawford (In re James River Coal Co.)*, 360 B.R. 139, 179 (Bankr. E.D. Va. 2007) (holding that insolvency does not change or alter the fiduciary duties owed by the directors, but that it merely adds creditors as another constituency to which duties are owed).

(n14)Footnote 14. The Delaware Court of Chancery, in *Trenwick America Litigation Trust v. Ernst & Young*, 906 A.2d 168, 205 (Del. Ch. 2006) explained that the board of an insolvent corporation may still pursue, in good faith, actions maximizing the value of the firm. The mere fact that such actions result in "deepening insolvency"--continued insolvency or an even more insolvent entity--does not in itself, give rise to a cause of action because the directors are protected by the business judgment rule (however, the court clarified that directors are not protected from other causes of action, such as breach of fiduciary duty and fraud). In *Gheewalla*, the Delaware Supreme Court further explained that "Delaware courts have traditionally been reluctant to expand existing fiduciary duties" and that these were not necessary to protect the rights of creditors, which are "afforded protection through contractual agreements, fraud and fraudulent conveyance law, implied covenants of good faith and fair dealing, bankruptcy law, general commercial law and other sources of creditor rights." *North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99 (Del. 2007) .

(n15)Footnote 15. 264 Md. 20, 284 A.2d 605 (1971) .

(n16)Footnote 16. *In re Xonics, Inc.*, 99 B.R. 870 (Bankr. N.D. Ill. 1989) .

(n17)Footnote 17. *Id.* at 876 . See also *In re Radnor Holdings Corp.*, 353 B.R. 820, 843 (Bankr. D. Del. 2006) (holding that the business judgment rule protects the directors of an insolvent corporation from liability to the creditors); *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 205 (Del. Ch. 2006) (stating that insolvency is but one of many factors a judge must consider in a business judgment determination).

(n18)Footnote 18. 305 N.Y. 1, 110 N.E.2d 397 (1953) .

(n19)Footnote 19. See, e.g., D. Block, S. Barton & S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers*, 599-600 (5th ed. 1998); Cook & Schwartz, *At a Troubled Company, Officers and Directors Owe Creditors First*, Nat'l L.J., Mar. 16, 1987, at 22.

(n20)Footnote 20. See *Chambers v. Bickle Ford Sales, Inc.*, 313 F.2d 252 (2d Cir. 1963) (sale and disposition of assets); *In re Baldwin Trading Corp.*, 8 N.Y.2d 144, 202 N.Y.S.2d 312, 168 N.E.2d 383 (1960) (dissolution). In a non-liquidation situation, it is highly unlikely that directors would be liable for breaching their duty of care to creditors, so long as the directors are not grossly negligent. See *Doyle v. Gordon*, 158 N.Y.S.2d 248, 264 (N.Y. Sup. Ct. 1954) (unlike the defendants in *Weiss*, "[the] defendants [here] neither discontinued the business of the corporation nor liquidated its assets. On the contrary, they continued to operate the [company] during very trying times and constantly sought to increase the revenue and assets of the corporation, rather than to dispose of them.").

(n21)Footnote 21. The "trust fund" doctrine has been most commonly used by a receiver in a state law insolvency proceeding seeking to recover corporate assets wrongfully distributed. It overlaps and supplements certain statutory remedies of creditors, such as provisions governing fraudulent conveyances, preferences or illegal dividends. See, e.g., *Automatic Canteen Co. v. Wharton*, 358 F.2d 587 (2d Cir. 1966) (illegal dividend); see also Morris, *Fiduciary Duties of the Debtor in Possession to Creditors and Shareholders*, 1988 ABA Section on Corporate, Banking & Business Law 5-6. Other cases have used the "trust fund" doctrine to invalidate transfers of assets of insolvent corporations when the transfers fell just outside the technical reach of the statutory provisions. See *Davis v. Woolf*, 147 F.2d 629 (4th Cir. 1945) .

(n22)Footnote 22. See *Am. Nat. Bank of Austin v. Mortgageamerica Corp. (In re Mortgageamerica Corp.)*, 714 F.2d 1266, 1269 (5th Cir. 1983) (holding that the trust fund "doctrine does not, in fact, involve the application of any actual 'trust' at all"). See also *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 791 (Del. Ch. 2004) (trust fund doctrine is "by no means universally praised"). The recognition of the limits of the trust fund metaphor run at least as far back the 1893 opinion of the United States Supreme Court in *Hollins v. Brierfield Coal and Iron Co.*, 150 U.S. 371 (stating that "it is true language has been frequently used to the effect that the assets of a corporation are a trust fund held by a corporation for the benefit of its creditors, this has not been to convey the idea that there is a direct and

express trust attached to the property").

(n23)Footnote 23. 3A Fletcher Cyc. Corp. § 1182 (rev. vol. 1994) ("[t]here is certainly no 'trust relation' in the proper sense of the term. ...").

(n24)Footnote 24. See *In re RegO Co.*, 623 A.2d 92, 109 n.35 (Del. Ch. 1992) ("When directors of a dissolved Delaware corporation are, during the course of winding-up corporate affairs, required to make decisions affecting various classes of interest holders, they are protected from liability in doing so, so long as they act disinterestedly, with due care and in good faith. Delaware law does not ... impose duties on directors of a dissolved corporation of the kind reflected in *N.Y. Credit Men's Adjustment Bureau v. Weiss.*") (citing *Devereux v. Berger*, 264 Md. 20, 284 A.2d 605 (1971) & *In re Xonics, Inc.*, 99 B.R. 870 (Bankr. N.D. Ill. 1989) (further citation omitted)). The holding in the currently leading case in Delaware makes plain that the trust fund doctrine, even were it applicable in Delaware, could not support the recognition of new fiduciary duties owed to creditors by directors of insolvent corporations. See *North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del.) (holding that directors of insolvent and nearly-insolvent corporations owe no direct fiduciary duties to creditors).

(n25)Footnote 25. 7A Pt. II U.L.A. 2 (1999). See P 4.06[3] *infra* for a discussion of these statutes.

(n26)Footnote 26. See, e.g., *Clarkson Co. v. Shaheen*, 660 F.2d 506 (2d Cir. 1981), *cert. denied*, 455 U.S. 990, 102 S. Ct. 1614, 71 L. Ed. 2d 850 (1982) (directors liable for breach of the duty of care owed to creditors because directors failed to prevent fraudulent loans made by corporation for the benefit of dominant director); *Wieboldt Stores, Inc. v. Schottenstein*, 20 C.B.C.2d 776, 94 B.R. 488 (N.D. Ill. 1988) (complaint alleging directors' personal interest in approving leveraged buy-out of insolvent corporation held sufficient to state a claim for breach of fiduciary duty).

(n27)Footnote 27. See, e.g., *Devereux v. Berger*, 264 Md. 20, 284 A.2d 605 (1971). As discussed in P 3.03[2] *supra*, current law in Delaware is that creditors of insolvent corporations, or those in the zone of insolvency, are owed no direct fiduciary duties, and may maintain only derivative claims on behalf of the insolvent corporation. *Gheewalla*, 930 A.2d at 101-03.

(n28)Footnote 28. See *Adelphia Communs. Corp. v. Rigas (In re Adelphia Commc'ns Corp.)*, 323 B.R. 345, 386 n.140 (Bankr. S.D.N.Y. 2005); *Prod. Res. Group, L.L.C. v. NCT Group, Inc.*, 863 A.2d 772, 789-92 (Del. Ch. 2004); *Continuing Creditors' Comm. of Star Telecomms., Inc. v. Edgecomb*, 385 F. Supp. 2d 449, 463-64 (D. Del. 2004); see generally J. F. Rydstrom, Annotation, *Liability of Corporate Directors for Negligence in Permitting Mismanagement or Defalcations by Officers and Employees*, 25 A.L.R.3d 941 (1969); see also *In re Linderman*, 20 B.R. 826 (Bankr. W.D. Wash. 1982) (denying stockholder-creditors the right to retain the proceeds of the sale of a corporate asset on the basis that the trust fund should be available for all of the creditors).

(n29)Footnote 29. *Koch Ref. v. Farmers Union Cent. Exch., Inc.*, 831 F.2d 1339, 1348, 18 C.B.C.2d 84, 88 (7th Cir. 1987), *cert. denied*, 485 U.S. 906, 108 S. Ct. 1077, 99 L. Ed. 2d 237 (1988); *In re MortgageAmerica Corp.*, 714 F.2d 1266, 1277, 9 C.B.C.2d 603, 616 (5th Cir. 1983); *Hassett v. McColley (In re O.P.M. Leasing Servs., Inc.)*, 28 B.R. 740, 759 (Bankr. S.D.N.Y. 1983).



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Collier Business Workout Guide

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CHAPTER 3 The Board of Directors in a Workout

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P 3.04 Fiduciary Duties of Directors in Negotiating a Workout.

[1] Deciding on a Restructuring Course.

The fiduciary duties of directors in situations in which a company is clearly solvent or insolvent are relatively straightforward, but how should the directors be advised when the financial condition of the company is less clear? What must the board do in deciding on a restructuring course? What if the board in good faith determines that despite its current financial problems, the company can be saved and made to provide greater enterprise value to its constituents in the future? How can the board balance the interests of creditors and shareholders in such a situation?

First, the board must oversee the process of investigation, analysis and planning that the company's management and its advisors will engage in during the process of deciding on a restructuring course.ⁿ¹ The extent to which the board itself will be involved in this process will vary from company to company, but at the very least the board should be asked to consider and approve important decisions along the way.

Next, as a backdrop to the decision-making process, the board must consider whether the company is in fact insolvent or navigating the "zone of insolvency."ⁿ² However, when the management of a company contemplating a restructuring is asked whether the company is insolvent, the answer generally ranges from "we really don't know" to "yes, but only for the time being and because of problems that are not indicative of future performance." The difficulties involved in defining insolvency, coupled with the management's understandable hopes that the company's present woes poorly reflect the true value of the enterprise, can leave the board operating in a gray area of responsibility.

This gray area is where the inherent conflicts between the interests of creditors and shareholders pose the most difficulty for the board.ⁿ³ Once the board has determined that the company can and should be restructured, it must decide how to resolve conflicts between shareholders and creditors over business decisions, and whether and to what extent it should negotiate a continuing equity participation in the restructured company on the shareholders' behalf.

[2] Definition of Insolvency: Calculation of Going Concern Value.

[a] Generally.

The advent of insolvency, in most jurisdictions, slants the board's fiduciary duties in favor of the creditors.ⁿ⁴ Therefore, defining the point at which the focus of those duties begins to shift from shareholders to creditors is essential. The

definition of insolvency can vary subtly in different situations and in different jurisdictions. One common definition is that a corporation is insolvent if the value of its assets is less than the amount that will be required to pay its liabilities as they become absolute and matured.ⁿ⁵ The Bankruptcy Code defines insolvency as the financial condition "such that the sum of ... [the] entity's debts is greater than all of such entity's property, at a fair valuation," excluding certain property.ⁿ⁶

Regardless of which definition of insolvency is used, corporate assets can be valued at the price they would bring if sold separately, or at the price they would bring if all assets of a business are sold as a single entity, *i.e.*, "going concern" value.ⁿ⁷ The method used can often depend on the circumstances in which the corporation is being valued. If a corporation is to be liquidated, it would appear proper to measure the corporation's assets at the value they would bring if sold separately.ⁿ⁸ On the other hand, "going concern value" should be used to determine the solvency of a corporation that is attempting to negotiate a workout and survive as a going concern.ⁿ⁹

To determine going concern value, the board will engage in certain analyses and examine various restructuring alternatives.ⁿ¹⁰ The following are some of the typical valuation methods that a corporate board and its financial advisors might use in assessing the company's going concern value.

[b] Comparable Company Analysis.

This method values a company by applying a ratio derived from the public markets' valuation of the financial performance of comparable companies in the same business or businesses as the subject company to the subject company's recent financial performance. The comparable company analysis involves computing the ratio that the stock price of the comparable companies bears to one or more indicators of these companies' financial performance, such as revenues, operating cash flow, operating income or net income, depending on the industry in which the companies operate. A blended ratio or a range of ratios is then applied to the subject company's revenues, operating cash flow, operating income or net income, as the case may be, usually for the previous four quarters. Although, in theory, this method should give effect to the public investors' view of the future of the business or businesses in which the company operates (as reflected in the comparable company ratio), it is often criticized in the troubled company context because the enterprise value only reflects the recent (and most likely depressed) performance of the company.

[c] Comparative Acquisition Analysis.

This method uses multiples derived from recent historical acquisitions of comparable companies and applies them to the company's current financial performance. Like the comparable company analysis, this method uses multiples of revenues, operating cash flow, operating income or net income, whichever is the most appropriate indicator. The blended multiple is then applied to the subject company's revenues, operating cash flow, operating or net income, as the case may be, again in most cases, over the most recent four quarters. This method is also criticized in the troubled company context because, as with comparable company analysis, it emphasizes recent financial performance and, in addition, looks at only historical acquisition prices which may no longer reflect the current market.

[d] Discounted Cash Flow Analysis.

This method is considered the most reliable indicator of enterprise value in the troubled company context. It is in essence a four-step process. First, the company projects its financial performance over a period of, typically, five years. Second, in order to estimate future value beyond that date, earnings in the terminal year are capitalized, using a range of multiples derived from comparable companies. Third, a discount rate (or a range of discount rates) is derived from the weighted average cost of capital over the projected period. Fourth, the discount rate is applied to both the projected financial indicators and the terminal value to arrive at an enterprise value. Because this method takes into account future performance of the troubled company, it is thought to provide a more balanced view of the company's value, particularly in light of its potential restructuring.

Thus, although the corporation may appear to be insolvent from its balance sheet, the board may conclude that the company is not insolvent when viewed as a going concern. Because a going concern valuation uses techniques that are by necessity imprecise and involve the forecasting of unpredictable future events, one cannot always determine with certainty whether or not a struggling company is insolvent.ⁿ¹¹ However, the directors do not have to make this determination alone. In most states, directors are protected from liability if they rely on the advice of professionals and corporate officers and employees whom the directors believe to be reliable and qualified.ⁿ¹²

[3] Managing the Company During the Workout.

The board may conclude that although the company is insolvent or close to insolvency, the underlying business is strong and, as a result, it is advantageous to all parties to keep the company alive. Restructuring the company might give the creditors a greater return over time and preserve some value for the shareholders. However, creditors and shareholders will often disagree strongly over business decisions the board must make during the restructuring. Legally, the board is not obligated to accede to the creditors' wishes in every instance.ⁿ¹³ Nonetheless, as a practical matter, lenders often have a right to declare a default and accelerate their loans to initiate bankruptcy proceedings, or to pursue other contractual remedies. These gives creditors significant leverage over the company.ⁿ¹⁴ The board will need to listen closely to the concerns of these creditors in order to best serve all constituencies.

As an example, during a workout, certain creditors may look to reduce their exposure by pressing the corporation to cut back on costs or to sell important assets.ⁿ¹⁵ If these measures are instituted, the shareholders may see the value of their equity decline. The creditors (at least the more senior creditors who will be first in line for the proceeds of asset sales) will be risk-averse and will want the company to sell its assets and use the proceeds to pay down debt.ⁿ¹⁶ The shareholders, on the other hand, will be in favor of delaying any asset sale and taking risks in the hope of seeing profits large enough to restore their equity in the corporation. They will want to hold on to the assets (despite the risk of depreciation), betting that the assets will appreciate in value.ⁿ¹⁷

The shareholders have everything to gain (the restoration of their equity) and little to lose (they presently have little or no equity) by taking this risk. The creditors, on the other hand, have much to gain (the repayment of the major portion of their debt) and little to lose (even if the assets appreciate, the creditors will never be paid more than in full) by selling the assets now and avoiding the risk of depreciation.

Despite the great leverage the creditors have in the restructuring of a troubled company, the law reflects the need to balance the interests of creditors and shareholders. For instance, in the analogous context of a chapter 11 reorganization, the court in *In re Lionel Corp.* resolved the issue described above in favor of the shareholders.ⁿ¹⁸ Lionel, as debtor in possession, sought permission under *section 363(b) of the Bankruptcy Code* to sell its most valuable asset, its subsidiary, Dale Electronics. The creditors' committee wanted to use the sale to create a "pot of cash" from which to pay the creditors' claims. The equity committee opposed the sale, in part because it believed that the shareholders could receive better treatment under the reorganization plan if they could delay or obstruct the sale and in part, perhaps, because they believed that Dale might appreciate, allowing them to share in its value.ⁿ¹⁹ The Court of Appeals for the Second Circuit refused to approve the sale, finding that there was no good business reason for it other than the creditors' committee's insistence on carrying it out.ⁿ²⁰ The court cited Congress' desire to counteract "the natural tendency of a debtor in distress to pacify large creditors with whom the debtor would expect to do business, at the expense of small and scattered public investors" and Congress' intention to "gran[t] to public investors the last chance to conserve values that corporate insolvency has jeopardized."ⁿ²¹

Directors should not take extraordinary risks without regard to creditor exposure in the hope of restoring shareholder equity. If the workout negotiations fail and it is clear that no hope remains, the directors may risk personal liability for a breach of the duty of loyalty to creditors if they fritter away the remaining corporate assets in a vain attempt to prolong the company's survival.

A Delaware case, *Credit Lyonnais Bank Nederland, N.V. v. Pathe Communications Corp.*,ⁿ²² also discussed the issue of balancing creditor and shareholder interests. In *Credit Lyonnais*, a corporation's 98.5% shareholder alleged that the corporation's executive committee had breached a fiduciary duty to him as shareholder by failing to facilitate certain asset sales.ⁿ²³ The corporation had just emerged from bankruptcy and all board power had been delegated to the executive committee pursuant to a corporate governance agreement with the corporation's bankruptcy lenders. Under the corporate governance agreement, control of the company would return to the shareholder if the corporation's indebtedness could be reduced below a certain level. In order to regain control of the corporation, the shareholder pushed for the sale of certain assets which would have the effect of reducing the indebtedness. The executive committee refused to sell the assets on the ground that the proposed price was insufficient.

The court held that the executive committee did not breach a duty of loyalty to the shareholder by not acquiescing in his desire to sell the assets. Because the corporation was in the "vicinity of insolvency," the executive committee was not "merely the agent of the residue risk bearers, but owe[d] its duty to the corporate enterprise."ⁿ²⁴ Even though the principal shareholder would have benefited from the sale of assets, the executive committee "had an obligation to the community of interest that sustained the corporation" to "maximize the corporation's long term wealth creating capacity."ⁿ²⁵

In a footnote, the court noted the right course to follow for the corporation "may diverge from the choice that the stockholders (or the creditors, or the employees, or any single group interested in the corporation) would make if given the opportunity to act."ⁿ²⁶ In a later opinion issued in *Production Resources Group, L.L.C. v. NCT Group, Inc.*,ⁿ²⁷ the Delaware Chancery Court made clear that its decision in *Credit Lyonnais* was intended to provide directors of an insolvent corporation with a shield against lawsuits brought by shareholders who allege damages from the directors' conservative strategy. It was *not* intended to provide a sword in the inverse situation, where creditors allege damages arising from the directors' good faith pursuit of a riskier--if ultimately unsuccessful--strategy to maximize value for the entire corporate enterprise, including for the benefit of shareholders.ⁿ²⁸ Accordingly, the *Credit Lyonnais* and *Production Resources* decisions should be read to give directors greater flexibility in making business decisions in the context of a restructuring, so long as such decisions are made on an informed basis and in good faith.

A more recent opinion issued by the Delaware Supreme Court, *North American Catholic Educational Programming Found., Inc. v. Gheewalla*, has provided additional flexibility and much-needed guidance to directors of struggling companies. North American Catholic Educational Programming Foundation, Inc., the owner of certain FCC-regulated radio wave spectrum licenses and Clearwire Holdings, Inc.'s major creditor, brought direct claims against Clearwire's directors for breaches of fiduciary duty, which allegedly occurred while Clearwire was insolvent or in the zone of insolvency. It alleged that the Clearwire directors failed to exercise their fiduciary duties by failing to preserve Clearwire's assets for the benefit of its creditors. The court affirmed the Court of Chancery's dismissal of the case on the basis that creditors are already afforded a variety of legal protections through their contractual agreements, that the costs outweighed the benefits, and that:

an otherwise solvent corporation operating in the zone of insolvency is one in most need of effective and proactive leadership--as well as the ability to negotiate in good faith with its creditors--goals which would likely be significantly undermined by the prospect of individual liability arising from the pursuit of direct claims by creditors. Directors of insolvent corporations must retain the freedom to engage in various, good faith negotiations with individual creditors for the benefit if the corporation.ⁿ²⁹

Furthermore, the court reasoned that recognizing that directors owe direct fiduciary duties to creditors of an insolvent corporation would "create a conflict between those directors' duty to maximize the value of an insolvent corporation for the benefit of all of those having an interest in it, and the newly recognized direct fiduciary duty to individual creditors."ⁿ³⁰

As discussed above, the standard by which directors' business decisions are judged in the workout context should not change from the standard used to judge the actions of the directors of a healthy company.ⁿ³¹ The directors of a troubled company enjoy the same protection of the business judgment rule.ⁿ³² Under the business judgment rule, courts will presume that directors have acted "on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company."ⁿ³³ Because it is impossible to satisfy all the constituencies of an overleveraged company, courts should allow considerable discretion to the board so long as the directors act reasonably and in good faith. Given the applicability of the business judgment rule, it is highly unlikely that a court would find the directors of a troubled company liable for breach of fiduciary duty for seeking to "aid the floundering corporation," unless it can be shown that the directors had ulterior motives or were reckless in their ignorance of the corporation's financial situation.ⁿ³⁴

[4] Negotiating on the Shareholders' Behalf.

[a] Shareholder Leverage.

When faced with the foregoing inherent conflicts of interest between creditors and shareholders, the directors of a corporation undergoing a restructuring will ask whether they should negotiate on behalf of the shareholders in fashioning the terms of the restructuring, or whether their sole constituency at that point is the creditors.

In analyzing workout negotiations, it is important to note that even where (due to insolvency) shareholders do not have a legal right to share in a restructured corporation, a company's creditors may be willing to allow the shareholders to retain a portion of the equity in the restructured company for the following reasons:

- State corporate law may require shareholder approval for a restructuring that involves a debt-equity exchange (for example, for the authorization of new shares or the reclassification of stock).
- Permitting the shareholders some return may avoid litigation, other delay and negative publicity.ⁿ³⁵
- If equity is held by management, as in many post-leveraged buyout situations, the creditors may permit the shareholders to retain equity as an inducement to keep management in place. A similar rationale applies to companies with a significant amount of employee stock ownership.

Moreover, the relative allocation of value between creditors and shareholders in a restructuring can be supported to an extent by the recovery each group could expect in a chapter 11 reorganization, where shareholders may retain some interest.

In 1990, Professors Lynn M. LoPucki and William C. Whitford published an extensive study of large, publicly held corporations that were reorganized under chapter 11.ⁿ³⁶ They examined the degree to which the actual allocation of value under chapter 11 settlements varied from the allocation that would have been appropriate if the parties' rights under the Bankruptcy Code had been strictly enforced. Thirty of the companies studied were insolvent, and the shareholders in these cases were therefore entitled to nothing. Nevertheless, in 21 of these 30 cases, the creditors allowed the shareholders to retain a percentage of the corporation's value, ranging from 1 percent to 57 percent of the total value of distributions to unsecured creditors and shareholders. Excluding one extraordinary case, the average shareholder recovery was 8.05 percent.

While the foregoing percentages have probably declined since the LoPucki-Whitford study was published, shareholder recoveries in chapter 11 reorganizations of insolvent publicly held companies are still not uncommon.ⁿ³⁷ Because of the need for shareholder approval of certain elements of an out-of-court restructuring, the shareholders may have even greater leverage in such a situation than they would in chapter 11, where the senior creditors can legally force the approval of a reorganization plan that gives the shareholders nothing. Indeed, Professors Julian Franks and Walter

Torous concluded (based on a sample of 37 chapter 11 reorganizations and 45 out-of-court restructurings) that the average shareholder recovery in out-of-court restructurings of companies with publicly traded debt is 9.5 percent of total corporate value, compared with 2.3 percent for chapter 11 reorganizations.ⁿ³⁸

In chapter 11 reorganization cases involving small corporations managed by their principal shareholders, the recoveries are much higher; the shareholders sometimes retain 100 percent of the stock of the reorganized company, while the claims of the unsecured creditors are significantly compromised.ⁿ³⁹ This is due in large part to the creditors' recognition of the dependence of the business on the management shareholders.ⁿ⁴⁰

[b] Directors' Allegiance.

The issue of board allegiance in workout negotiations has been only obliquely explicitly addressed in the case law.ⁿ⁴¹ However, for the following reasons, the board may be justified in negotiating on the shareholders' behalf regarding the capital structure of the reorganized company without violating a fiduciary duty to creditors:ⁿ⁴²

- State corporate law, which applies regardless of a company's financial difficulties, provides universally that directors are elected by the shareholders. As stated by the Supreme Court of Delaware, "insolvency alone, irrespective of degree, does not divest the stockholders of a ... corporation of their right to exercise the powers of corporate democracy."ⁿ⁴³ In addition, if the workout succeeds, the current shareholders will remain constituents of the board in the future.
- As indicated above, state law may require the shareholders' approval for some corporate actions necessary to complete a restructuring.ⁿ⁴⁴
- The shareholders are often the only unrepresented class in a workout negotiation (senior and subordinated creditors generally have financial advisors and/or counsel to assist them) and must look to management to protect their interests. As one commentator summarized the matter, "if management holds out for a distribution to equity, it usually will succeed."ⁿ⁴⁵
- As discussed above, it is often inherently unclear whether a troubled company is actually insolvent.ⁿ⁴⁶
- If the corporation is not insolvent, directors would be remiss if they abdicated the responsibility they owe to shareholders.ⁿ⁴⁷
- As discussed below, the law governing the analogous area of chapter 11 reorganizations clearly contemplates situations where the board will negotiate on behalf of shareholders.ⁿ⁴⁸

[5] Analogy to Bankruptcy Law.

[a] Theory of the Bankruptcy Code.

The proposition that the directors of a company facing a restructuring are permitted to negotiate on behalf of the shareholders has some support in the theory, legislative history, case law and commentary relating to the Bankruptcy Code.ⁿ⁴⁹ While not directly relevant, these bankruptcy concepts shed some light on what actions are appropriate for a board of an insolvent company that has not filed for bankruptcy.

Because the Bankruptcy Code has as one of its theoretical underpinnings the rehabilitation of the debtor, it embodies certain concepts that encourage settlements among creditor and shareholder classes.ⁿ⁵⁰ This statutory bias towards negotiated settlements tends to result in shareholders ending up with a share in the reorganized company exceeding

what they would have received in an adjudicated reorganization.ⁿ⁵¹ For instance, the Bankruptcy Code's chapter 11 relaxed the "absolute priority rule" that applied in Chapter X of the old Bankruptcy Act.ⁿ⁵² The rigidity of that rule was one of the reasons that Chapter X proceedings were rarely utilized. The rule effectively prevented consensual plans because it gave each individual creditor a veto over plans that awarded any recovery to shareholders unless all senior classes were paid in full.ⁿ⁵³ Under chapter 11, shareholders can receive a recovery in a negotiated plan even over the objections of dissenting creditors, so long as the dissenting creditors do not make up the majority of any particular class of creditors.

In addition, the Bankruptcy Code also encourages negotiated settlements by providing for a 120-day period during which the debtor has the exclusive right to propose a plan of reorganization.ⁿ⁵⁴ The original 120-day period, however, may not be extended beyond a date that is 18 months after the order for relief is entered.ⁿ⁵⁵ The debtor may use the extended period of time during which it controls the development of a plan of reorganization as leverage to negotiate a plan that will provide some recovery to all classes, including the shareholders.

[b] Legislative History.

The legislative history of the Bankruptcy Code also supports the view that the shareholders can have a role in the rehabilitation of the debtor. The Senate Report on the Bankruptcy Reform Act of 1978 stated:

In a large public company, whose interests are diverse and complex, the most vulnerable today are public investors who own subordinated debt or equity securities. The bill ... is designed to counteract the natural tendency of a debtor in distress to pacify large creditors, with whom the debtor would expect to do business, at the expense of small and scattered public investors. ... A fair and equitable reorganization, as provided in the bill, is literally the last clear chance to conserve for them values that corporate financial stress or insolvency have placed in jeopardy.ⁿ⁵⁶

The House Report contains this comment:

The bill does not impose a rigid financial rule for the plan. The parties are left to their own to negotiate a fair settlement. The question of whether creditors are entitled to the going-concern or liquidation value of the business is impossible to answer. It is unrealistic to assume that the bill could or even should attempt to answer that question. Instead, negotiation among the parties after full disclosure will govern how the value of the reorganizing company will be distributed among creditors and stockholders. The bill only sets the outer limits on the outcome: it must be somewhere between the going-concern value and the liquidation value.

Only when the parties are unable to agree on a proper distribution of the value of the company does the bill establish a financial standard The important difference [from prior law] is that the bill permits senior classes to take less than full payment, in order to expedite or insure the success of the reorganization.ⁿ⁵⁷

[c] Bankruptcy Case Law: The Shareholder Meeting Cases.

Courts have generally held that shareholders of corporations in bankruptcy have the right to call meetings and elect directors even when their purpose is to ensure themselves a recovery in the bankruptcy. For instance, in *Saxon Industries, Inc. v. NKF Partners*,ⁿ⁵⁸ the Supreme Court of Delaware affirmed a lower court order compelling a corporation in a chapter 11 reorganization to hold a shareholders' meeting for the purpose of electing new directors. The corporation's board pointed out that the shareholders' only purpose in requesting the meeting was to achieve a higher payment in the reorganization. Even though the corporation had a \$200 million deficit, the court ruled that "a stockholder's right to have a meeting convened to elect directors is 'virtually absolute' "ⁿ⁵⁹ and that "insolvency [does] not divest the stockholders of their right to elect directors."ⁿ⁶⁰

[d] Commentary.

When it comes to negotiating the allocation of value between shareholders and creditors, the relationship between a bankrupt corporation's management and its creditors is appropriately adversarial. Even though the debtor in possession does owe fiduciary duties to the creditors,ⁿ⁶¹ one commentator has observed that an adversarial relationship exists between creditors and the directors of a debtor in possession as well:

[T]he suggestion that the duty extends so far as to oblige management to tailor a plan to fit the demands of creditors is unwarranted and unrealistic. The formulation of a reorganization plan is an exercise in business prognostication, valuation, and, most of all, negotiation. ... [A]lthough equity may bar officers and directors from engaging in waste or self dealing, equity does not [sic] command directors to yield to every demand that creditors make.

. ...

[I]n negotiating a plan, the relationship of the debtor and its creditors is essentially adversarial [sic].ⁿ⁶²

[6] How Forcefully Should Directors Represent Shareholders' Interests?

Although there is much justification for the directors to protect shareholders' interests in workout negotiations, the non-bankruptcy case law does not address how far the directors should go in attempting to negotiate an increase in the value of equity's share in the restructured company.

Even when the board does its best to represent shareholder interests in a restructuring, the realities of a workout situation and the omnipresent threat of bankruptcy may force the board to concur in substantial concessions to the creditors and massive dilution for the shareholders. The dynamics of the negotiation will always be informed by what each constituency would receive in a bankruptcy proceeding as opposed to an out-of-court restructuring.

The bankruptcy case law has drawn some limits beyond which shareholders may not go in attempting to replace the board. The case law also limits the ability of shareholders to attempt to increase their recovery by obstructionist tactics such as "strike suits." These bankruptcy cases may provide some guidance for directors in out-of-court workouts.

In *In re Johns-Manville Corp.*,ⁿ⁶³ the court said that the equity committee's demand for a shareholder meeting should be honored unless the committee demonstrated bad faith, *e.g.*, a willingness to risk rehabilitation altogether in order to win a larger share for equity.ⁿ⁶⁴

However, the court in *In re Potter Instrument Co.* ⁿ⁶⁵ barred a special stockholder's meeting demanded by the corporation's founder and 45-percent stockholder. The court referred to the founder's "frustra[tion] in his efforts to smash the [c]ompanies which he brought into being because he has been ousted from management and control."ⁿ⁶⁶

In re Heck's Properties, Inc. ⁿ⁶⁷ illustrates an example of overreaching by shareholders (or at least, by their attorneys). In *Heck's*, the bankruptcy court sharply reduced the fees of the lawyers for the shareholders' committee of a company in chapter 11. The lawyers had brought a suit against the corporation's management charging that, by approving a plan of reorganization that diluted the interests of the shareholders, management had violated its fiduciary duties to the shareholders.

The court held that the suit was "unnecessary and inappropriate" because the dilution of the shareholders' interest was valid in light of the debtor's negative net worth and the fact that the plan allowed the shareholders to retain ten percent of the reorganized company. "The sole motivation for bringing this complaint seems to have been to obstruct the Plan confirmation process."ⁿ⁶⁸ In further reducing the equity counsel's fees, the court described the lead attorney's conduct

by reference to allegations that "Equity Counsel attempted to browbeat and intimidate counsel for the Debtors, the Trade Committee and the Bank Committee with threats of all-out 'warfare' if the Plan was not altered to provide the Stockholders with a yet more generous recovery."n69

In the workout context, these cases imply that there are limits beyond which the directors of insolvent companies should not go in negotiating forcefully on behalf of the shareholders: the directors should not engage in obstructionist tactics that jeopardize the chance for a successful restructuring in order to attempt to win an inappropriately large recovery for the shareholders. By contrast, the directors continue to have the option of filing a petition in chapter 11 if they believe that it is the best way to preserve the corporation's value or to maximize the shareholders' recovery. A good faith decision to file for chapter 11 protection will not expose the directors to risk of personal liability to either shareholders or creditors.n70 In both in-court and out-of-court restructurings it may be difficult to know when equity is asking for "too much," given the range of possible shareholder recoveries. This is an area largely unaddressed by case law. How to advise a board making a determination on this issue is one of the greatest challenges facing counsel to a troubled company today.

FOOTNOTES:

(n1)Footnote 1. See ch. 2 *supra* for a description of this process.

(n2)Footnote 2. See *North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 101 (Del. 2007) .

(n3)Footnote 3. The Delaware courts have recently offered a degree of comfort and clarity to directors "navigating the zone of insolvency," *id.*, with respect to the beneficiaries of their fiduciary duties. But the judgment and decision-making duties themselves--such as those regarding negotiations, lines of business, and corporate fiscal planning--will generally continue to require careful assessment of solvency.

(n4)Footnote 4. See P 3.03[1] *supra*.

(n5)Footnote 5. See, e.g., *N.Y. Debt. & Cred. Law* § 271; see also Unif. Fraudulent Conveyance Act § 2, 7A Pt. II U.L.A. 22 (1999) (a person is insolvent "when the present fair saleable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured").

(n6)Footnote 6. 11 U.S.C. § 101(32)(A).

(n7)Footnote 7. *In re Wendy's Food Sys., Inc.*, 82 B.R. 898, 899-900 (Bankr. S.D. Ohio 1988) .

(n8)Footnote 8. See *In re Taxman Clothing Co.*, 905 F.2d 166, 170 (7th Cir. 1990) , *reh'g en banc denied*, 1990 U.S. App. LEXIS 13764 (7th Cir. Aug. 7, 1990) ; see also *In re Bellanca Aircraft Corp.*, 56 B.R. 339, 387 (Bankr. D. Minn. 1985) , *aff'd in part, remanded in part*, 850 F.2d 1275, 20 C.B.C.2d 19 (8th Cir. 1988) ("Only where a business is wholly inoperative, defunct, or dead on its feet, will going concern valuation be abandoned in favor of an item by item fair market valuation.").

(n9)Footnote 9. See generally 2 *Collier on Bankruptcy*, P 101.32[4] (Matthew Bender 15th Ed. Revised) (discussing insolvency valuation in general, not in the specific context of fiduciary duties); G. Newton, *Bankruptcy and Insolvency Accounting--Practice and Procedure* 60 (Wiley 4th ed. 1989) (same).

(n10)Footnote 10. See ch. 2 *supra* for a discussion of this analytical review.

(n11)Footnote 11. See *Consol. Rock Prods. Co. v. Du Bois*, 312 U.S. 510, 526, 61 S. Ct. 675, 685, 994 (1941) (since going concern valuation requires a prediction as to what will happen in the future, "an estimate, as distinguished from mathematical certitude, is all that can be made"); see also Coogan, *Confirmation of a Plan Under the Bankruptcy Code*, 32 Case W. Res. L. Rev. 301, 313 n.62 (1982); H.R. Rep. No. 59-595, 95th Cong., 1st Sess. 222 (1977),

reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised) (valuation is usually "a guess compounded by an estimate"). An alternative definition to balance sheet insolvency is that of equitable insolvency, which suggests that a business entity is insolvent once it becomes unable to pay its debts as they become due in the regular course of business. See, e.g., *Official Creditors Comm. of Indus. Ceramics, Inc. v. Indus. Ceramics Assocs. (In re Indus. Ceramics, Inc.)*, 253 B.R. 323, 332 (Bankr. W.D.N.Y. 2000) ; *N.Y. Bus. Corp. Law § 102(a)(8)* (McKinney 2005) (defining insolvency); *Barron's Dictionary of Finance and Investment Terms* 281 (5th ed. 1998) (same).

(n12)Footnote 12. See P 3.02 [1], n.10 and accompanying text *supra*.

(n13)Footnote 13. See *Katz v. Oak Indus., Inc.*, 508 A.2d 873 (Del. Ch. 1986) (holding that the directors of a "company in deep trouble" could, in order to "buy the company time," force debt holders to choose between tendering debt securities in exchange for common stock or cash in an amount less than the face value of the obligation--but at a premium over market prices--or consenting to dilution of the debt holders' protective covenants); n.38 *infra*; cf. *In re Lionel Corp.*, 722 F.2d 1063, 9 C.B.C.2d 941 (2d Cir. 1983) (reorganization under chapter 11; discussed at text accompanying ns.15-18 *infra*); Gerber, *The Election of Directors and Chapter 11--The Second Circuit Tells Stockholders to Walk Softly and Carry a Big Lever*, 53 Brooklyn L. Rev. 295, 350-51 (1987) ["Gerber"] (discussing fiduciary duties of corporate debtors in possession).

(n14)Footnote 14. *North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 103 (Del. 2007)

(n15)Footnote 15. See generally Jackson, *Ethical Considerations in Bankruptcy: The Case of Corporate Governance*, National Conference of Bankruptcy Judges (Nov. 1988).

(n16)Footnote 16. See Roe, *Bankruptcy and Debt: A New Model for Corporate Reorganization*, 83 Colum. L. Rev. 527, 542 (1983) ["Roe"] ("Creditors in general are not necessarily interested in maximizing the viability of the firm. Ordinarily ... they want to obtain the greatest value as early as possible.").

(n17)Footnote 17. See Bebchuk, *A New Approach to Corporate Reorganizations*, 101 Harv. L. Rev. 775, 780 n.19 (1988) ("[A] delay often might be in the interest of equityholders. When the value of the reorganized company is lower than the total value of creditors' claims, the equityholders might have nothing to lose and something to gain from a delay.").

(n18)Footnote 18. 722 F.2d 1063, 9 C.B.C.2d 941 (2d Cir. 1983) .

(n19)Footnote 19. See Gerber, n.13 *supra*, at 351 .

(n20)Footnote 20. *In re Lionel Corp.*, 722 F.2d 1063, 1071, 9 C.B.C.2d 941, 950 (2d Cir. 1983) .

(n21)Footnote 21. *In re Lionel Corp.*, 722 F.2d 1063, 1070, 9 C.B.C.2d 941, 949-50 (2d Cir. 1983) (citing S. Rep. No. 95-989, 95th Cong., 2d Sess. 10-11 (1978), reprinted in Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed.Revised)); see generally *In re Crowthers McCall Pattern, Inc.*, 114 B.R. 877 (Bankr. S.D.N.Y. 1990) (reviewing *Lionel* and its progeny).

(n22)Footnote 22. *Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp.*, No. 12150, 1991 Del. Ch. LEXIS 215 *108 (Del. Ch. Dec. 30, 1991) .

(n23)Footnote 23. *Id.* at *106 .

(n24)Footnote 24. *Id.* at *108 .

(n25)Footnote 25. *Id.* at *109 .

(n26)Footnote 26. *Id.* at *108 n.55 . It should be noted, however, that the court was describing a *solvent* corporation in the vicinity of insolvency.

(n27)Footnote 27. 863 A.2d 772 (Del. Ch. 2004) .

(n28)Footnote 28. *Id.* at 788-89 .

(n29)Footnote 29. *North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92 103 (Dec. 2007) .

(n30)Footnote 30. *Id.* Most, but not all, courts in other jurisdictions that have considered their own corporate law in light of *Gheewalla* have followed its reasoning to foreclose direct actions by creditors against directors of companies either insolvent or in the zone of insolvency. Compare *In re Felt Mfg. Inc.*, 371 B.R. 589, 611 (Bankr. D.N.H. 2007) (applying New Hampshire law consistent with *Gheewalla*) and *In re Mooney*, No. 05-13392, 2007 WL 2403774, at *2 (Bankr. D.N.H. Aug. 17, 2007) (applying New Massachusetts corporate law consistent with *Gheewalla*) and *Metcoff v. Lebovics*, 51 Conn. Supp. 68 (Conn. Super. Ct. 2007) (applying Connecticut law consistent with *Gheewalla*) with *Jetpay Merchant Services LLC v. Miller*, 2007 WL 2701636, at *7 (N.D. Tex. 2007) (considering Colorado corporate law to be inconsistent with *Gheewalla*).

(n31)Footnote 31. *Id.* at 101.

(n32)Footnote 32. In a 2002 case before the Delaware Court of Chancery, Vice Chancellor Lamb held that the business judgment rule was the appropriate standard of care to apply in the context of a fiduciary duty owed to creditors. In *Angelo, Gordon & Co., L.P. v. Allied Riser Commc'ns Corp.*, 2002 Del. Ch. LEXIS 11 (Del. Ch. Jan. 30, 2002) , holders of notes evidencing debt owed by Allied Riser Communications, a telecommunications company, sought to enjoin a merger between the defendant and Cogent Communications, Group, Inc., an Internet service provider. *Id.* at *1 , *14. The plaintiffs argued that the proposed merger, which would subordinate their debt, was a breach of both contractual and fiduciary duties, and sought an injunction to prevent the merger. See *id.* at 1 . The court recognized that Allied Riser, "due to its balance sheet insolvency," owed a fiduciary duty to the noteholders. *Id.* at *19 . However, the court declined to find a breach, noting that the debt securities were not in default, and did not substantially restrict the defendant's ability to enter into the merger. *Id.* at *22 . The court applied a business judgment standard in reaching its conclusion, noting that

[E]ven where the law recognizes that the duties of directors encompass the interests of creditors, there is room for application of the business judgment rule. Thus, I tentatively conclude that, to overcome the presumption of regularity attending the application of the business judgment rule, plaintiffs must carry an initial burden of showing circumstances supporting an inference that the directors did not act in good faith after a reasonable investigation. On the record before me, they have not met this burden with respect to the directors' financial interests.

Id. at *22 (footnotes omitted).

(n33)Footnote 33. *Smith v. Van Gorkom*, 488 A.2d 858, 872 (Del. 1985) (citation omitted).

(n34)Footnote 34. See, e.g., *Angelo, Gordon & Co., L.P. v. Allied Riser Commn'cs Corp.*, 2002 Del. Ch. LEXIS 11 (Del. Ch. Jan. 30, 2002) (applying the business judgment standard in reaching its decision that directors of an insolvent corporation did not breach fiduciary duties owed to its creditors in reaching a merger agreement). See also *Steinberg v. Kendig (In re Ben Franklin Retail Stores)*, 225 B.R. 646 (Bankr. N.D. Ill. 1998) , *aff'd in relevant part*, 43 C.B.C.2d 9, 1999 U.S. Dist. LEXIS 16645 (N.D. Ill. Oct. 20, 1999) , *clarified* 2000 U.S. Dist. LEXIS 276 (N.D. Ill. 2000) (finding no breach of fiduciary duty to creditors by directors who altered certain accounts receivable in hopes of returning the debtor corporations to financial health); *Miramar Res., Inc. v. Shultz (In re Shultz)*, 208 B.R. 723, 730 (Bankr. M.D. Fla. 1997) (excepting from bankruptcy discharge of a debt owed to creditor corporation based on defendant director's

"reckless disregard" of the rights of the shareholders and other directors).

(n35)Footnote 35. See *Roe*, n.15 *supra*, at 543 .

(n36)Footnote 36. LoPucki & Whitford, *Bargaining Over Equity's Share in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 139 U. Pa. L. Rev. 125 (1990) ["LoPucki & Whitford"].

(n37)Footnote 37. In 1993, Professors LoPucki and Whitford published a follow-up article, reviewing the status of the cases originally examined in the 1990 study. See Lynn M. LoPucki & William C. Whitford, *Patterns in the Bankruptcy Reorganization of Large, Publicly Held Companies*, 78 Cornell L. Rev. 597 (1993). Professor LoPucki continues to maintain the Bankruptcy Research Database, a comprehensive electronic catalog of all large, publicly-held corporations, with assets worth over \$100 million (in 1980-valued dollars), that have filed for bankruptcy in the United States since 1980. An abbreviated version of the database is available to the public at no charge, at <http://lopucki.law.ucla.edu>.

(n38)Footnote 38. Franks & Torous, *A Comparison of Financial Recontracting in Distressed Exchanges and Chapter 11 Reorganizations*, 35 J. Fin. Econ. 349, 350 (1994). Franks and Torous explain that the higher shareholder recovery in out-of-court restructurings, as opposed to chapter 11 reorganizations, represents what certain creditors are willing to give up in order to avoid chapter 11 and its costs and delays.

(n39)Footnote 39. See LoPucki & Whitford, n. 36 *supra*, at 149 ("the claims of creditors are compromised, but shareholder-managers usually retain their shares without dilution").

(n40)Footnote 40. *Id.*

(n41)Footnote 41. See *North Am. Catholic Ed. Programming Found., Inc. v. Gheewalla*, 930 A.2d 92, 99, 103 (Del. 2007) (holding it "well established" that the directors owe their fiduciary obligations to the corporation *and* its shareholders, even when insolvent, and stating that directors "must retain the freedom to engage in vigorous, good faith negotiations with individual creditors").

(n42)Footnote 42. Legal commentary on closely related themes lends strength to this thesis. See Coogan, Bermant & Glatt, *Panel Discussion: The Problems of the Sinking Ship*, 31 Bus. Law. 1371, 1375 (1976) (remarks of Mr. Glatt) ("The trust fund doctrine, to the extent it is presently viable would, in my judgment, have to bow to the obligation which I believe the directors owe the debtor and its shareholders. If there is an honest belief on the part of management that the debtor can be resuscitated, I believe that the directors have the duty to do their very best to preserve the debtor's viability and maximize the recovery to shareholders."); see also *Katz v. Oak Indus., Inc.*, 508 A.2d 873 (Del. Ch. 1986) , in which the court was asked to enjoin an exchange offer made by a corporation to the holders of its long-term debt. The company had a \$62,000,000 deficit in its stockholders' equity account, a fact that could certainly have led the court to conclude that the company was insolvent. However, at the time of the lawsuit, a restructuring was on the table that would reduce the corporation's long-term debt by 85%. Without specifically mentioning the possibility of Oak's insolvency, the court held that the directors of Oak owed no fiduciary duties to its debt holders. See *id.* at 879 .

(n43)Footnote 43. *Saxon Indus., Inc. v. NKFW Partners*, 488 A.2d 1298, 1300 (Del. 1984) .

(n44)Footnote 44. See P 3.04[4][a] *supra*.

(n45)Footnote 45. LoPucki & Whitford, n.33 *supra*, at 159 (discussing the representation of equity, by either committee or management, as a method of being "present at the bargaining table" during a reorganization).

(n46)Footnote 46. See P 3.04[2] *supra*.

(n47)Footnote 47. See P 3.03[1] *supra*.

(n48)Footnote 48. See P 3.04[5] *infra*.

(n49)Footnote 49. See *Commodity Futures Trading Comm'n v. Weintraub*, 471 U.S. 343, 355, 105 S. Ct. 1986, 1994, 85 L. Ed. 2d 372, 382, 12 C.B.C.2d 651, 658 (1985) ("the fiduciary duty of the trustee runs to shareholders as well as to creditors"); *Pepper v. Litton*, 308 U.S. 295, 307, 60 S. Ct. 238, 245, 84 L. Ed. 281, 289-90 (1939) ("in the event of bankruptcy ... [the] fiduciary obligation is designed for the protection of the entire community of interests in the corporation--creditors as well as stockholders") (footnotes omitted); *In re Lionel Corp.*, 722 F.2d 1063, 1069-71, 9 C.B.C.2d 941, 948-50 (2d Cir. 1983) (construing 11 U.S.C. §§ 363(b) & 1101 *et seq.* in light of the legislative history underlying chapter 11).

For another discussion of this topic (in the chapter 11 context), see Case, *Fiduciary Duty of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases*, in ALI-ABA Williamsburg Conference on Bankruptcy 373 (1988). Mr. Case posits that directors of companies in chapter 11 should be able to resolve conflicts in favor of the creditors or the shareholders, or alternatively, remain neutral and act as mediators, as long as the directors disclose which approach they are taking and each constituency is adequately represented:

For example, in the case of a smaller, family-owned debtor where the creditors have (or have waived) the opportunity to be represented and the family officer-directors have made it clear that they are looking out for themselves, the Pro-Equity Theory of resolving Conflict Among Beneficiaries seems correct.

By contrast, in a hopelessly insolvent situation where chapter 11 is used as a vehicle for liquidation, assuming that disclosure and adequate representation of excluded constituencies have been achieved (or waived), it seems proper for the officers and directors to invoke the Pro-Creditor Theory to resolve Conflict Among Beneficiaries.

The Stakeholder-Mediator Theory might best be invoked in the cases of some large, publicly-held debtors. Here each constituency normally has its own committee, and the board can announce its intent to achieve a consensual plan. To this end, the board can promote compromise and seek peace without fear of liability to any constituency by reason of how it elects, in the particular circumstances, to resolve Conflict Among Beneficiaries.

Id. at 384 .

(n50)Footnote 50. See LoPucki & Whitford, n.36 *supra*, at 141-76.

(n51)Footnote 51. See n.54 and accompanying text *infra*.

(n52)Footnote 52. See 124 Cong. Rec. 34,004 (1978) (statement of Sen. DeConcini).

(n53)Footnote 53. See 7 *Collier on Bankruptcy*, P 1129.LH[4][a] (Matthew Bender 15th Ed. Revised) (describing absolute priority rule).

(n54)Footnote 54. 11 U.S.C. § 1121(b). In the case of a small business debtor, the exclusive period is 180 days. 11 U.S.C. § 1121(e)(1), as amended by Pub. L. No. 109-8 (2005).

(n55)Footnote 55. 11 U.S.C. § 1121(d)(2)(A), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. The ability to determine if and when to file a plan of reorganization is often an important source of leverage for debtors in negotiations with creditors. Under prior law, the debtor had the exclusive right to file a plan of reorganization for 120 days after the bankruptcy court entered the order for relief. The court had

the power to reduce or increase the 120-day period for cause after notice and a hearing, but the law did not impose any limits on the number or length of extensions, and, in practice, courts were extremely lenient in extending the exclusivity period. The amendments end this practice of granting unlimited extensions by limiting the court's ability to extend the debtor's exclusivity period. Different time periods and extension standards are applicable in small business cases. *See 11 U.S.C. § 1121(e)*, as amended in 2005.

(n56)Footnote 56. S. Rep. No. 95-989, 95th Cong. 2d Sess. 10 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n57)Footnote 57. H.R. Rep. No. 95-595, 95th Cong., 1st Sess. 224 (1978), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised) (footnotes omitted).

(n58)Footnote 58. *488 A.2d 1298 (Del. 1984)* .

(n59)Footnote 59. *Id. at 1301* .

(n60)Footnote 60. *Id. at 1302* ; *see also In re Allegheny Int'l, Inc.*, 1988 WL 212509 (W.D. Pa. May 31, 1988) (shareholders' meeting where dissident shareholders planned to wage a proxy fight permitted); *In re Harper Indus., Inc.*, 18 B.R. 773, 775 (Bankr. S.D. Ohio 1982) ("Replacement of management remains the prerogative of the Board of Directors (and ultimately the stockholders). ..."). *But see Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.)*, 801 F.2d 60, 64-65, 15 Collier Bankr. Cas. 2d (MB) 645, 646 (2d Cir. 1986) (suggesting that it is proper to deny shareholders of an insolvent company the right to call a meeting for the purpose of ousting management). The court's suggestion in *Johns-Manville* has been called into question by legal commentators. *See* Gerber, n.13 *supra*, at 353-56; Morris, *Fiduciary Duties of the Debtor in Possession to Creditors and Shareholders*, 1988 ABA Section on Corporate, Banking & Business Law 12.

(n61)Footnote 61. Gerber, n.13 *supra*, at 350.

(n62)Footnote 62. *Id. at 350-51* (discussing *In re Lionel Corp.*, 722 F.2d 1063, 9 C.B.C.2d 941 (2d Cir. 1983)) .

(n63)Footnote 63. *801 F.2d 60*, 15 C.B.C.2d 645 (2d Cir. 1986) .

(n64)Footnote 64. *801 F.2d 60*, 65, 15 C.B.C.2d 645, 651 .

(n65)Footnote 65. *593 F.2d 470* (2d Cir. 1979) .

(n66)Footnote 66. *593 F.2d 470*, 474 .

(n67)Footnote 67. *112 B.R. 775 (Bankr. S.D. W. Va. 1990)* , *aff'd in relevant part, rev'd in part*, *151 B.R. 739 (S.D. W. Va. 1992)* .

(n68)Footnote 68. *Id. at 802* .

(n69)Footnote 69. *Id. at 807* (citation omitted).

(n70)Footnote 70. Jerome, *Stockholders v. General Creditors*, in 1977 ALI-ABA Course of Study on Business Workouts 59, 63.



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Collier Business Workout Guide

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CHAPTER 3 The Board of Directors in a Workout

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P 3.05 Protecting Directors and Officers From Liability.

[1] Overview.

Directors and officers of a financially troubled corporation face increased risk of personal liability as the corporation slips toward insolvency. Directors and officers of insolvent corporations and corporations in the "vicinity of insolvency" may face financial exposure arising from legal accountability for a variety of claims,ⁿ¹ including breach of fiduciary duty and claims arising under state and federal securities laws.ⁿ²

Directors and officers may also face contractual liability, for example, for debt of the insolvent company that they personally guaranteed.ⁿ³

Directors and officers of insolvent corporations may also face a loss of compensation. An officer whose compensation or retirement package includes equity incentives could lose thousands or millions of dollars, as the insolvent corporation's stock plummets. A terminated officer may be left with only an unsecured claim for severance or for termination damages under an employment contract.ⁿ⁴ In addition, the Bankruptcy Code limits an employee's claim pursuant to a terminated employment contract to amounts due under the contract, plus compensation for one year following the earlier of the filing of the bankruptcy petition or the employee's termination date.ⁿ⁵ The Bankruptcy Code also limits the amount of incentive compensation that senior management is entitled to receive in the nature of retention bonuses and similar payments. *Section 503(c) of the Bankruptcy Code* prohibits any payment to, or transfer incurred for the benefit of, an insider (in this context, the officers and directors of the debtor) "for the purpose of inducing such person to remain with the debtor's business" unless the bankruptcy court finds that several tests are satisfied.ⁿ⁶

Similarly, Section 503(c) prohibits any severance payment to an insider unless the payment is part of a program generally applicable to all full-time employees and the amount of the payment is not greater than ten times the amount of the mean severance given to non-management employees during the calendar year.ⁿ⁷ Finally, Section 503(c) prohibits other transfers or obligations that are "outside of the ordinary course of business and not justified by the facts and circumstances of the case."ⁿ⁸ This last prohibition is not limited to insiders.

With so many potential liabilities, a question present in many directors' and officers' minds is whether they should resign or stay on during the restructuring process.ⁿ⁹ This portion of the chapter will examine certain methods employed to protect officers and directors from personal liability for actions taken in their official capacities.

There are three basic methods of limiting the risk of personal liability for directors:

- (1) inserting provisions in the corporation's certificate of incorporation to limit or eliminate directorial liability under certain circumstances;
- (2) indemnifying directors for settlements, judgments and legal expenses under statutes, corporate bylaws or contracts with individual directors; and
- (3) purchasing liability insurance.

[2] Certificate of Incorporation Provision Limiting Liability.

Since 1986, the Delaware General Corporation Law has allowed a corporation to include in its certificate of incorporation a provision eliminating or limiting directorial liability for breach of the duty of care, so long as the director's action did not constitute an act or omission involving bad faith, intentional misconduct or a knowing violation of law, and so long as the director did not derive an improper personal benefit.ⁿ¹⁰ Most other states provide similar protections for directors.ⁿ¹¹

Although such a provision affords considerable relief to directors, effectively shielding them from liability for gross negligence, this protection is subject to several limitations. The Delaware statutory provision, for instance, protects a director only from liability based on acts or omissions occurring after the provision is included in the certificate of incorporation. In addition, the statutory exculpation applies only to actions taken in a director's capacity as a director, and not to actions taken by a director in his or her capacity as an officer. Another important qualification is the exclusion of violations of the duty of loyalty from the purview of the statute. Most significantly, because the exculpation provision must be included in the corporation's certificate of incorporation, it cannot be enacted without the requisite shareholder approval.

[3] Indemnification.

All fifty states have statutes dealing with indemnification of corporate directors and officers.ⁿ¹² The statutes typically provide for three types of indemnification: (1) mandatory indemnification; (2) permissive indemnification; and (3) indemnification pursuant to a bylaw provision or contract.

[a] Mandatory Indemnification.

Indemnification statutes typically require the corporation to indemnify a director or officer for expenses incurred in successfully defending an action. Delaware's provision requires indemnification for expenses actually and reasonably incurred "to the extent that a present or former director or officer of a corporation has been successful on the merits or otherwise."ⁿ¹³ Under Delaware law, partial success in a litigation requires partial indemnification and even success on procedural grounds alone requires indemnification.ⁿ¹⁴ Other states may not allow partial indemnification or may provide for mandatory indemnification only for success on the merits.ⁿ¹⁵

[b] Permissive Indemnification.

In Delaware, permissive indemnification is authorized by statute when the director or officer has acted in good faith and in the reasonable belief that his or her actions were in, or not opposed to, the best interests of the corporation.ⁿ¹⁶ The indemnification must be approved by a majority of a quorum of disinterested directors.ⁿ¹⁷ If the quorum is unavailable or if the quorum so directs, then the decision to indemnify can be made by independent legal counsel or the stockholders.ⁿ¹⁸

The scope of the allowable indemnification depends on whether the litigation is brought against the directors by a third party or derivatively by shareholders in the name of the corporation. Indemnification statutes are most expansive when permitting indemnification for third-party actions. In Delaware, so long as the director or officer acted in good faith and reasonably believed that his or her actions were not opposed to the best interests of the corporation, the director may be indemnified for expenses, settlements, fines and judgments incurred in defending a non-derivative third-party action.ⁿ¹⁹

The Delaware statutory indemnification provisions for derivative actions are far more narrow than the provisions for third-party actions. While the applicable standard of conduct is the same (*i.e.*, good faith and reasonable belief that the actions are not opposed to the corporation's best interests), a director may only be indemnified for expenses incurred in defending a derivative suit.ⁿ²⁰ The statute does not authorize indemnification for amounts paid in settlement of derivative actions and prohibits indemnification for expenses if the director is adjudged liable to the corporation, except upon court order.ⁿ²¹ The rationale for the different treatment of third-party claims and derivative actions is that in derivative actions the corporation is the true plaintiff. Because all money recovered from a director in a derivative action is paid to the corporation, the entire purpose of the derivative action would be undermined if the corporation had to indemnify the director.ⁿ²²

[c] Advancement of Litigation Expenses.

A majority of indemnification statutes permit a corporation to advance litigation expenses to a director or officer.ⁿ²³ Delaware permits these advances after the director or officer agrees "to repay such amount if it shall ultimately be determined that such person is not entitled to be indemnified."ⁿ²⁴ A determination that the director or officer has satisfied the requisite standard of conduct is not required prior to the advancement of expenses. Delaware has also eliminated the requirement that advancement of litigation expenses be authorized by the board of directors in specific cases.ⁿ²⁵

[d] Other Bylaw and Contractual Provisions.

The law of Delaware,ⁿ²⁶ and of other states as well,ⁿ²⁷ provides that the statutory indemnification provisions are not exclusive. This allows a corporation to bind itself in its bylaws or by contract to indemnify an officer or director in circumstances that the statute does not specifically mandate. Thus, although bylaw or contractual provisions that go beyond the limits of permissive indemnification statutes may, in certain circumstances, be struck down by a court for reasons of public policy,ⁿ²⁸ these indemnification provisions should, in the interest of the directors, obligate the corporation to pay indemnification in all circumstances not prohibited by statute and to advance litigation expenses on demand.ⁿ²⁹

[4] Indemnification in the Troubled Company Context.

[a] Indemnification Sought Prior to Bankruptcy Filing.

When a corporation experiences financial difficulties, the availability of indemnification protection may decrease significantly. Even if a corporation has adopted a mandatory indemnification bylaw provision to supplement the relevant corporate statute, the corporation may be simply unable to honor its obligation due to lack of funds. In addition, any indemnification payments made to directors and officers within one year prior to the filing of a petition under chapter 11 of the Bankruptcy Code may be recoverable by the debtor's estate as a preferential transfer if the corporation was insolvent at the time of the payment.ⁿ³⁰

[b] Indemnification Sought After Bankruptcy Filing.

If the corporation files a petition under chapter 11 before a director is able to recover indemnification payments from the corporation, the director will probably face significant difficulties in obtaining indemnification.

[i] Automatic Stay.

Section 362(a)(3) of the Bankruptcy Code automatically stays "any act to obtain possession of property of the estate." While the stay is in effect, it will prevent the director or officer from collecting on an indemnification claim that arose before the filing.ⁿ³¹ Ultimately, the director or officer may collect the indemnification claim pursuant to a plan of reorganization or liquidation. The indemnification claim, however, will be a general unsecured claim and the director or officer will only share *pro rata* in whatever recovery is awarded to general unsecured claims. Because secured and administrative claims have priority over unsecured claims,ⁿ³² the director or officer will usually receive a recovery representing only a percentage of his or her total claim. It is also possible that the director's claim would be subordinated under the Bankruptcy Code to other general unsecured claims.ⁿ³³ In addition, because of the automatic stay, no matter how great the director's ultimate recovery, the director may need to advance his or her own share of litigation expenses if the litigation continues during the bankruptcy.ⁿ³⁴

[ii] Indemnification Claims as Administrative Expenses.

A director with a prepetition indemnification claim will be able to increase his or her ultimate recovery and/or immediately obtain an advance on litigation expenses if the director can successfully argue that the indemnification claim is entitled to administrative expense status as an "actual and necessary cost" of preserving the estate.ⁿ³⁵ The relevant case law, however, is not encouraging, and is more favorable to current (as opposed to former) directors.

[A] Former Directors.

The indemnification claims of former directors (*i.e.*, directors who are no longer acting as such during the bankruptcy proceedings) are not administrative expenses. Since a former director is no longer providing any benefit to the estate, the debtor cannot argue that paying the indemnification claim is an "actual and necessary cost" of preserving the estate of the corporation in chapter 11.ⁿ³⁶

[B] Current Directors.

The cases discussing indemnification claims by directors who are continuing to serve during the chapter 11 case are in conflict. In *In re Amfesco Industries, Inc.*,ⁿ³⁷ the bankruptcy court denied the current directors' claim for administrative priority. The court adopted a two-part test for the granting of an administrative priority: "administrative priority is granted only where the claim ... (1) 'arise(s) from a transaction with the debtor-in-possession' and (2) 'is beneficial to the debtor-in-possession in the operation of the business.'" ⁿ³⁸

In denying the request for administrative priority, the court noted as follows:

All of the operative facts, legal relationships, and conduct of the [directors] upon which is based the threatened litigation occurred pre-petition. The indemnification agreement [was] entered into ... pre-petition [and any] duty ... to indemnify the [directors] arises from services provided to the pre-petition Corporation [,] not for services rendered post-petition to the Debtors-in-Possession. As such, the [directors'] claim arises from their pre-petition services rather than any post-petition services.ⁿ³⁹

In re Baldwin-United Corp. ⁿ⁴⁰ presents a slightly more permissive approach. Although the court denied administrative priority to the indemnification claims of former directors, it left open the possibility of administrative priority for the claims of present directors, even though the claims arose out of prepetition acts. The *Baldwin* court stated that the activities of each director individually must be examined to determine whether the estate would benefit from that director's continued services. The court noted that if the directors condition their continued service on the payment of indemnification claims prepetition-based, then it is possible that the payment of these claims is an "actual and necessary" cost of preserving the estate.ⁿ⁴¹

Directors and officers should also consider the debtors' co-liability on claims, which may further limit their ability to be indemnified. In *Sorenson v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*,ⁿ⁴² a former officer of Drexel filed a proof of claim seeking indemnification for a potential judgment against him and for legal costs arising therefrom.ⁿ⁴³ Drexel faced co-liability on the judgment, and contested the claim.ⁿ⁴⁴ The court noted that, pursuant to *section 502(e)(1)(B) of the Bankruptcy Code*, contingent claims involving co-liability must be disallowed.ⁿ⁴⁵ The court, discussing the decision in *In re Wedtech Corp.*,ⁿ⁴⁶ articulated a three-part test pursuant to which qualification under *section 502(e)(1)(B)* is determined: "(i) the claim must be one for reimbursement or contribution; (ii) the entity asserting the claim for reimbursement or contribution must be 'liable with the debtor' on or have secured the claim of a creditor; and (iii) the claim must be contingent at the time of its allowance or disallowance."ⁿ⁴⁷ The court, noting that the former officer had filed the proof of claim before any liability had been assigned, found that the officer's claims for indemnification and attorney's fees fell within *section 502(e)(1)(B)*, and were thus disallowed.ⁿ⁴⁸

It is clear that administrative priority for indemnification claims is not something that directors can count on, given the conflict among the cases and the difficulty of proving that a particular director's continued services are of sufficient benefit to justify the granting of an administrative priority.

[iii] Indemnification Claims Arising After Bankruptcy Filing.

Unlike indemnification claims arising out of prepetition acts, directors can be fully and timely reimbursed for litigation expenses (and, in certain circumstances, settlements and judgments) that arise out of claims based on postpetition acts or omissions. In several recent cases, debtors have applied for and received orders allowing the payment of these expenses as an administrative priority.ⁿ⁴⁹

[5] Possible Solutions to the Funding and Bankruptcy Code Problems With Indemnification.

[a] Creating a Trust.

One possible solution to the problems described above is to create an irrevocable trust to fund future indemnification claims and expenses. If the trust is properly structured, the directors may be able to collect their indemnification claims in full and without regard to the automatic stay, because the trust will not be considered property of the bankruptcy estate.

In order for the trust to not be considered property of the estate, the corporation must truly divest itself of the trust assets. The trust should meet the following conditions to increase the likelihood that a court will consider the corporation to have truly divested itself of the trust assets:

- (1) the trust must be irrevocable and the terms not amendable by the corporation;
- (2) the power to terminate the trust, replace the trustee and appoint the residual interest should belong to the beneficiaries (*i.e.*, the directors and former directors), not the corporation;
- (3) the trust should prohibit payment of the residual interest to the corporation or its creditors until the expiration of an appropriately long period (*e.g.*, ten years); and
- (4) investment of the trust fund should be controlled by the trustee, not the corporation.

Even if the steps outlined above are taken, the trust does not ensure complete protection. The question most often raised is whether there is a proper corporate purpose for the funding of the trust. It is therefore inadvisable for a corporation to fund an indemnification trust with sufficient assets to cover large judgments against directors and officers. A better use of the trust will be to reimburse or advance to the directors the expenses of litigation.

Even if the trust is designed only to cover litigation expenses, if it is established when the corporation is insolvent, the transfer of funds can be challenged as a fraudulent conveyance.ⁿ⁵⁰ To lessen the risk of such a challenge, the beneficiaries of the trust (the directors) should be asked to commit formally to continue to provide services to the debtor for at least some minimum period of time. In addition, the trust instrument should recite as consideration that the directors' services are necessary and beneficial to the corporation. Despite such precautions, it may still be possible for a party to attack the trust as a fraudulent conveyance by alleging that the directors' continued services did not represent fair consideration relative to the amount the corporation conveyed to the trust.ⁿ⁵¹

[b] Alternatives to the Trust.

One alternative to establishing a trust is to secure the indemnification obligation with unencumbered corporate assets. This has the advantage of not draining the company of funds. However, the automatic stay may still prevent the directors from obtaining their litigation expenses on demand.ⁿ⁵² In addition, if the corporation granted the security interest while insolvent, it could be subject to the same fraudulent conveyance concerns as the trust.ⁿ⁵³ Another option is to have a subsidiary guarantee the parent's indemnity obligations. This option should only be relied on if the subsidiary has enough assets not to be rendered insolvent by the guarantee, and is sufficiently divorced from the finances and operations of its parent that it is unlikely that it will be affected by the parent's bankruptcy case.

[6] Insurance.

[a] Director and Officer Liability Insurance in the Context of a Healthy Company.

A director and officer ("D&O") liability policy ordinarily covers liability that may, under corporate law, be indemnified by the insured corporation. A D&O liability policy also insures against certain forms of liability that may not be indemnified directly by the corporation.

Accordingly, Delaware law, as well as the laws of many other states, allows a corporation to maintain insurance for a director or officer against liability "whether or not the corporation would have the power to indemnify him against such liability."ⁿ⁵⁴ Although D&O liability insurance policies do not cover deliberate misconduct, they usually do cover judgments and settlements of derivative actions, which are generally not indemnifiable under corporate law.

[b] Insurance in the Troubled Company Context.

By purchasing a D&O policy, a corporation supports its obligations to pay indemnification to a third party with the claims-paying ability of the insurer. The policy usually reimburses the insured corporation for amounts paid for indemnification. However, if the Bankruptcy Code or the financial condition of the insured corporation prevents it from paying an indemnifiable obligation, the director or officer (each of which is also an insured under the D&O policy) may make a claim directly against the insurer. The primary risks of non-payment or partial payment are that the claim may be excluded from coverage under the D&O policy,ⁿ⁵⁵ the D&O carrier seeks to rescind the policy on grounds that the application contained false information, or that the insurer is insolvent.ⁿ⁵⁶ Since the solvency of the insured corporation is a key underwriting factor from the insurers' viewpoint, a troubled corporation could well find that the insurance company will not renew the D&O policy upon expiration.

The Bankruptcy Code may also interfere with directors' and officers' ability to benefit from the proceeds of D&O policies. Some courts have held that upon a bankruptcy filing, D&O policies become part of the bankruptcy estate, thus subjecting the policies to the automatic stay.ⁿ⁵⁷ However, a number of cases distinguish between the policy itself and its proceeds. Depending on the terms of the policy, and whether the debtor itself can claim a current interest in the proceeds (e.g., if the debtor is a named defendant in an action), the proceeds may not enter the bankruptcy estate.ⁿ⁵⁸ Competing claimant issues arise when a policy, purchased by the debtor, names both the company (so-called "entity coverage"), and its officers and directors as co-extensive beneficiaries under the policy, so that both the debtor and its

officers and directors have an interest in the policy's proceeds. Such an occasion arises when both the debtor and its officers and directors have been named as defendants in a prepetition action.ⁿ⁵⁹ Where there is no entity coverage, or the debtor company has not been named as a defendant, it is more difficult to argue that the proceeds are property of the estate.ⁿ⁶⁰ It is thus vital that director and officer insurance policies are worded carefully, for example, specifically allocating a portion of the proceeds directly to the directors and officers,ⁿ⁶¹ or granting first priority to directors and officers.ⁿ⁶² Such an allocation or prioritization is particularly important when, as is common, overall coverage is structured such that indemnification to directors, under one policy, effectively diminish payments available to the bankruptcy organization, under another linked policy.

To the extent insurance policies or proceeds are deemed property of the estate, the automatic stay is implicated.ⁿ⁶³ The possibility of an automatic stay issue has led a number of insurance carriers to seek relief from the stay, before advancing funds pursuant to such a policy.ⁿ⁶⁴ Bankruptcy courts in both Delaware and New York, without directly addressing whether or not the insurance proceeds are property of the estate and thus subject to the automatic stay, have recently been willing to grant such relief "to the extent applicable."ⁿ⁶⁵

[c] Claims Made Policies Versus Occurrence Policies; Cancellation.

D&O liability policies are typically written as "claims-made" as opposed to "occurrence" policies. This means that the policy will only provide coverage for claims made against the insured while the policy is in effect. If the policy is no longer in effect when the claim against the insured is made, the insurer will not make any payments, even if the underlying occurrence took place while the policy was still in effect, unless the corporation has purchased extended discovery period coverage such as that described below. Occurrence policies, such as a corporation's commercial general liability insurance policy, provide coverage for claims arising out of events occurring while the policy is in effect, without regard to when the claim is made.

D&O insurance policies are generally subject to cancellation on 30 or 45 days' notice at the option of the insurer, although many state insurance laws may mandate a longer notice period and/or prohibit mid-term cancellations due solely to claim experience.ⁿ⁶⁶ If, however, before the effective date of cancellation, the corporation provides the insurer with notice of an occurrence which may later give rise to a claim, most policies state that the claim will be deemed made while the policy was in effect, even if the policy has already been cancelled by the time the claim is actually made. Furthermore, if the corporation files a petition in bankruptcy before the insurer cancels the coverage, it is possible that the insurer will be prohibited from cancelling the policy. For instance, in *In re Minoco Group of Companies, Ltd.*,ⁿ⁶⁷ the Ninth Circuit held that an insurer is automatically stayed under *section 362(a) of the Bankruptcy Code* from cancelling prepaid excess D&O liability insurance policies of a corporation in chapter 11. The court reasoned that D&O policies are property of the estate because they benefit the corporation by insuring it against indemnity claims made by directors and officers.ⁿ⁶⁸

Even if the policy is cancelled, the insured corporation still has the right to an extended period of coverage, upon payment of an additional premium. The "extended discovery period" ranges, depending on the policy, from 90 days to one year. It provides coverage for claims made during the extended period, but only if the occurrence giving rise to the claim took place prior to the policy termination date (effective date of cancellation). Since it is possible that the insurer will cancel the policy when the corporation encounters financial problems, it is very much in the directors' interest for the corporation to purchase a policy with the longest possible "extended discovery period."

[d] An Alternative Form of Insurance: Captive Insurer Subsidiaries.

In order to stabilize premiums and assure future coverage, some corporations have eschewed commercial D&O insurance in favor of captive insurer subsidiaries. A captive insurer subsidiary is commonly created by a family of affiliated corporations. It is owned by the group and insures only group members. A captive insurer subsidiary can issue D&O insurance to a group member and may be able to do so at a time when D&O insurance may be otherwise

unavailable from commercial insurers.

A captive insurer subsidiary may continue to provide coverage to directors and officers of an affiliated corporation that has filed a petition under chapter 11, provided that the subsidiary is not insolvent and is not rendered insolvent by the assumption of the insurance obligation.ⁿ⁶⁹ Incorporating the captive insurer subsidiary in a non-U.S. jurisdiction may increase the likelihood that the subsidiary will not be affected by a case under the Bankruptcy Code involving a member of its affiliate group.

FOOTNOTES:

(n1)Footnote 1. See John J. Rapisardi and Mark G. Douglas, *Looking Elsewhere for Creditor Recovery: Insurance Claims, D&O Actions, Inter-Creditor Remedies and Hidden Jewels*, 276-77 (American Bankruptcy Institute, May 6, 2002) ("Possible claims include breach of fiduciary duty, civil conspiracy to effect a fraudulent conveyance, aiding and abetting a breach of fiduciary duty, unlawful stock repurchase, and unlawful dividend or distributions.").

(n2)Footnote 2. Directors and officers may face liability under several provisions of the Securities Act of 1933 (the "1933 Act") and the Securities Exchange Act of 1934 (the "1934 Act"), including the following:

- (a) Section 10(b) of the 1934 Act and SEC Rule 10b-5 (promulgated under the 1934 Act), which prohibit manipulative or deceptive devices in connection with a purchase and sale of securities;
- (b) Section 11 of the 1933 Act, which prohibits misleading statements or omissions of material facts in a registration statement in connection with a public offering of securities;
- (c) Section 12 of the 1933 Act, which prohibits misleading statements or omissions of material facts in a prospectus used in the sale of securities;
- (d) Section 16 of the 1934 Act, which prohibits the purchase and sale of stock by directors, officers and owners within a six-month period; and
- (e) "control person" liability, which arises under both Acts.

See, e.g., *Director's & Officer's Liability* § 6:3 (Practicing Law Institute 2001). Directors and officers may also face liability under the individual states' Blue Sky laws.

(n3)Footnote 3. See *id.* at 277 .

(n4)Footnote 4. Courts have routinely defined two types of severance pay as "pay at termination in lieu of notice; [and] pay at termination based on length of employment." *In re Health Maint. Found.*, 680 F.2d 619, 621 (9th Cir. 1982) . Payment at termination in lieu of notice is considered a "cost of administration," and is entitled to administrative status. See *id.* However, in most jurisdictions, priority will only be granted to the portion of a severance package that derives from services rendered postpetition. See, e.g., *In re Mammoth Mart*, 536 F.2d 950, 953, 9 C.B.C. 159, 162 (1st Cir. 1976) ("only that portion of the severance pay claim which can be apportioned to services performed after the filing of the arrangement may be afforded [priority status]."). See also *Former Employees of Builders Square Retail Stores v. Hechinger Inv. Co. (In re Hechinger Inv. Co.)*, 298 F.3d 219, 227 (3d Cir. 2002) ("severance pay claims 'only have administrative priority to the extent that they are based on services provided to the bankruptcy estate post-petition' ") (quoting *In re Roth Am., Inc.*, 975 F.2d 949, 957, 27 C.B.C.2d 1125, 1137 (3d Cir. 1992)) ; *In re Health Maint. Found.*, 680 F.2d at 621 (severance pay based on length of service not entitled to administrative priority) *quoted with approval by Henderson v. Powermate Holdings Corp. (In re Powermate Holdings Corp.)*, 394 B.R. 765, 775-76 (Bankr. D. Del. 2008) . Only the Second Circuit has found that severance packages based on duration of service are entirely entitled to administrative status where termination occurs postpetition. See, e.g., *W. T. Grant Co. v. Rodman*, 620 F.2d 319, 321 (2d Cir. 1980), 22 C.B.C. 618 , *cert. denied Morgan Guar. Trust Co. v. Rinier*, 446 U.S. 983, 100 S. Ct. 2963, 64 L. Ed.

2d 839 (1980) ("the entire portion of the employees' severance pay claims is entitled to first priority as costs and expenses of administration"); *In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey*, 160 B.R. 882, 890 (Bankr. S.D.N.Y. 1993) ("the Second Circuit stands alone in holding that severance pay is always an administrative expense when termination occurs postpetition, regardless of the dubious benefit to the estate."); *In re St. Louis Globe-Democrat, Inc.*, 86 B.R. 606 (Bankr. E.D. Mo. 1988) (approving the reasoning of the Second Circuit's decisions); *but see In re AcoustiSeal, Inc.*, 50 C.B.C.2d 451, 290 B.R. 354 (Bankr. W.D. Mo. 2003) (siding with the majority approach). However, even the Second Circuit has denied contractual severance payments to highly-paid executives terminated postpetition. *See, e.g. Cohen v. Drexel Burnham Lambert Group, Inc.*, 26 C.B.C.2d 1128, 138 B.R. 687 (Bankr. S.D.N.Y. 1992) (denying severance payment to general counsel who was terminated shortly after debtor's filing, and limiting claimant's administrative claim to the one-year limit set pursuant to *Section 502(b)(7) of the Bankruptcy Code*).

(n5)Footnote 5. *See section 502(b)(7) of the Bankruptcy Code.*

(n6)Footnote 6. 11 U.S.C. § 503(c)(1), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. Under prior law, debtors often sought to institute key employee retention programs, or KERPs, shortly after the commencement of a bankruptcy case. Prior law allowed the court to approve a KERP if the debtor exercised proper business judgment in formulating the plan and if the court found the plan to be reasonable and fair. The new provision greatly reduces judicial discretion in reviewing such programs. First, the payment or obligation must be essential to the retention of such person "because the individual has a bona fide job offer from another business at the same or greater rate of compensation." 11 U.S.C. § 503(c)(1)(A). Second, the services provided by such person must be "essential to the survival of the business." 11 U.S.C. § 503(c)(1)(B). Finally, the amount of the payment or obligation must not exceed ten times the mean of similar payments made to non-management employees for any purpose during the calendar year. 11 U.S.C. § 503(c)(1)(C). If no such payments were made to non-management employees during the calendar year, the amount cannot exceed 25 percent of the amount of any similar transfer or obligation made to, or incurred for the benefit of, such person during the prior year. 11 U.S.C. § 503(c)(1)(C)(ii).

(n7)Footnote 7. In a related change, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amends *Section 548 of the Bankruptcy Code*, the Code's fraudulent conveyance provision, to provide that any payment to, or for the benefit of, an insider and any obligation incurred to, or for the benefit of, an insider under an employment contract is fraudulent if made or incurred in exchange for less than a reasonably equivalent value and not in the ordinary course of business. No showing is required with respect to the debtor's solvency or financial condition.

(n8)Footnote 8. 11 U.S.C. § 503(c)(3).

(n9)Footnote 9. *See discussion P 3.06 infra .*

(n10)Footnote 10. *Del. Code Ann. tit. 8, § 102(b)(7)*. A survey of the relevant laws of all states is beyond the scope of this chapter. The authors have therefore concentrated on the law of Delaware, occasionally referring to the laws of other jurisdictions.

(n11)Footnote 11. *See Cumulative Supplement to J. Bishop, Law of Corporate Officers and Directors: Indemnification & Insurance* App. E, at 195-99 (Callaghan 1990) ["Bishop"], for a table comparing these statutes in various states.

(n12)Footnote 12. *See Bishop, n.11 supra , App. D, at 189-99 , for a chart of the features of the indemnification statutes of all fifty states.*

(n13)Footnote 13. *Del. Code Ann. tit. 8, § 145(c)*; *see also N.Y. Bus. Corp. Law § 723(a)* (McKinney 2005). Amended *Del. Code Ann. tit. 8, § 145*, effective August 1, 2009, added new language in subsection 145(f) protecting directors from unanticipated elimination of indemnity after the fact: "A right to indemnification or to advancement of expenses arising under a provision of the certificate of incorporation or a bylaw shall not be eliminated or impaired by

an amendment to such provision after the occurrence of the act or omission that is the subject of the civil, criminal, administrative or investigative action, suit or proceeding for which indemnification or advancement of expenses is sought, unless the provision in effect at the time of such act or omission explicitly authorizes such elimination or impairment after such action or omission has occurred."

(n14)Footnote 14. *Del. Code Ann. tit. 8, § 145(c)*.

(n15)Footnote 15. *See, e.g., Cal. Corp. Law § 317(d)*.

(n16)Footnote 16. *Del. Code Ann. tit. 8, § 145(a), (b)*.

(n17)Footnote 17. *Del. Code Ann. tit. 8, § 145(d)*.

(n18)Footnote 18. *Id.*

(n19)Footnote 19. *Del. Code Ann. tit. 8, § 145(a)*.

(n20)Footnote 20. *Del. Code Ann. tit. 8, § 145(b)*.

(n21)Footnote 21. *Id.*

(n22)Footnote 22. *See Johnston, Corporate Indemnification and Liability Insurance for Directors and Officers, 33 Bus. Law. 1993, 1997 (1978)*.

(n23)Footnote 23. *See Bishop, n.11 supra*.

(n24)Footnote 24. *Del. Code Ann. tit. 8, § 145(e)*.

(n25)Footnote 25. *Del. Code Ann. tit. 8 § 145(f)*.

(n26)Footnote 26. *Id.*

(n27)Footnote 27. *See Bishop, n.11 supra*.

(n28)Footnote 28. E. Norman Veasey, *et al., Delaware Supports Directors with a Three-Legged Stool of Limited Liability, Indemnification, and Insurance, 42 Bus. Law. 399, 414 (1987)*. In *Levy v. HLI Operating Co., Inc.*, 924 A.2d 210 (Del. Ch. 2007), then-Vice Chancellor Lamb held that a director's fees and expenses must be paid by the director in the context of an unsuccessful effort to enforce a corporation's indemnification obligations, in spite of the corporation's prior unconditional agreement to bear such expenses. The court struck down that provision on the basis of public policy, noting that "[t]he law should not encourage directors and officers to bring non-meritorious indemnification claims against the corporation, and the provision at issue here clearly creates a perverse incentive to do so." *Id.* at 226-27.

(n29)Footnote 29. Veasey, *supra* note 28, at 415.

(n30)Footnote 30. 11 U.S.C. § 547(b). If the payment is made within 90 days prior to a filing, insolvency will be presumed. 11 U.S.C. § 547(f).

(n31)Footnote 31. *See, e.g., In re Johns-Manville Corp.*, 57 B.R. 680 (Bankr. S.D.N.Y. 1986) (automatic stay prevents parties with indemnification claims from proceeding against the debtor without first obtaining bankruptcy court permission).

(n32)Footnote 32. *See 11 U.S.C. §§ 503(b)(1)(A), 507(a)(2)* (administrative expenses).

(n33)Footnote 33. *See 11 U.S.C. § 510(b)*, which subordinates claims for reimbursement or contribution "arising

from rescission of a purchase or sale of a security of the debtor or of an affiliate of the debtor, for damages arising from the purchase or sale of such a security, or for reimbursement or contribution allowed ... on account of such a claim." *Section 510(c) of the Bankruptcy Code* gives the court further discretion to subordinate claims after notice and a hearing. *See 11 U.S.C. § 510(c)*. *See also In re Mid-American Waste Sys., Inc.*, 228 B.R. 816 (Bankr. D. Del. 1999), in which the court denied administrative priority to indemnification claims of directors and officers, finding that the "indemnification claims are merely claims for prepetition compensation for services rendered, not unlike salary or other benefits." *Id.* at 821. The court then subordinated the claims to all other general unsecured claims in the case, finding that *Bankruptcy Code section 510(b)* is "unambiguous in requiring the subordination of [indemnification claims of officers and directors] both for liability and expenses, resulting from securities law claims by purchasers or sellers of a debtor's securities." *Id.* at 829. *But see In re Christian Life Ctr.*, 821 F.2d 1370 (9th Cir. 1987) (denying administrative status to directors' and officers' claims for legal expenses, which arose from prepetition services, but finding section 510(b) inapplicable to defense costs, and thus declining to subordinate the claims). It is of note that *In re Christian Life* was decided pursuant to an earlier version of *section 510(b) of the Bankruptcy Code*, which has been amended to clarify that section 510(b) subordinates all allowed claims for reimbursement or contribution, including those on account of such a claim. *11 U.S.C. § 510(b)*. "On account of" has been interpreted to include claims for legal expenses. *See, e.g., In re Mid-American Waste Sys., Inc.*, 228 B.R. at 826. *See also In re De Laurentiis Entertainment Group, Inc. Painewebber, Inc. (In re De Laurentiis Entm't Group, Inc.)*, 124 B.R. 305, 308 (C.D. Cal. 1991) (finding that, under the "plain language" of section 510(b), "[r]eimbursement by definition includes indemnification, and indemnification naturally includes recovery of attorneys' fees").

(n34)Footnote 34. In some cases, suits against directors may be stayed on the grounds that they will impede the progress of the chapter 11 case. *See, e.g., A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1008, 15 C.B.C.2d 235, 252-53 (4th Cir. 1986); *In re Johns-Manville Corp.*, 10 C.B.C.2d 643, 40 B.R. 219 (S.D.N.Y. 1984).

The average reported cost of defending a D&O liability suit among one broad group of United States and Canadian companies in 2005 was over \$1,000,000. *Towers-Perrin D&O Liability 2005 Survey on Claims and Insurance Purchasing Trends*, p.8.

(n35)Footnote 35. *See 11 U.S.C. §§ 503(b)(1)(A), 507(a)(2)*. *See also In re Baldwin-United Corp.*, 11 C.B.C.2d 1391, 1401, 43 B.R. 443, 451 (S.D. Ohio 1984) (citing *Section 503(b)(1)(A) of the Bankruptcy Code*); *In re Mid-American Waste Sys., Inc.*, 228 B.R. at 821 (same); *In re Philadelphia Mortgage Trust*, 117 B.R. 820, 827-28 (Bankr. E.D. Pa. 1990) (citations omitted).

(n36)Footnote 36. *See, e.g., In re Baldwin-United Corp.*, 11 C.B.C.2d 1391, 43 B.R. 443 (S.D. Ohio 1984); *In re Summit Metals, Inc.*, 379 B.R. 40, 55-56 (Bankr. D. Del. 2007) (stating that, in order for a request to be allowed under section 503(b)(1)(A), the applicant must prove that the debt arises from a transaction with the debtor-in-possession and that the consideration supporting the claimant's right to payment is beneficial to the debtor-in-possession in the operation of the business).

(n37)Footnote 37. 81 B.R. 777 (Bankr. E.D.N.Y. 1988).

(n38)Footnote 38. *Id.* at 784 (quoting *In re Mammoth Mart*, 536 F.2d 950, 954, 9 C.B.C. 159 (1st Cir. 1976)).

(n39)Footnote 39. *Id.* at 784.

(n40)Footnote 40. 11 C.B.C.2d 1391, 43 B.R. 443 (S.D. Ohio 1984).

(n41)Footnote 41. *See 11 C.B.C.2d at 1415, 43 B.R. at 462.*

(n42)Footnote 42. 146 B.R. 92 (S.D.N.Y. 1992).

(n43)Footnote 43. *See id.* at 93. *Section 502(e)(1)(B) of the Bankruptcy Code* states in relevant part: "[T]he court

shall disallow any claim for reimbursement or contribution of an entity that is *liable with the debtor on* or has secured the claim of a creditor, to the extent that ... such claim for reimbursement or contribution is contingent as of the time of allowance or disallowance of such claim for reimbursement or contribution." 11 U.S.C. § 502(e)(1)(B) (emphasis added).

(n44)Footnote 44. 146 B.R. at 93 .

(n45)Footnote 45. *Id.* at 95-96 .

(n46)Footnote 46. 85 B.R. 285 (Bankr. S.D.N.Y. 1988) .

(n47)Footnote 47. 146 B.R. at 95 ; see *In re Wedtech Corp.*, 85 B.R. at 289 (citing *In re Provincetown-Boston Airlines, Inc.*, 72 B.R. 307, 309 (Bankr. M.D. Fla. 1987)) .

(n48)Footnote 48. 146 B.R. at 97 . See generally *In re Wedtech Corp.*, 85 B.R. 285 (Bankr. S.D.N.Y. 1988) (applying three-prong test and disallowing indemnification to former director and officer on numerous securities claims on which the debtor might be co-labile).

(n49)Footnote 49. See, e.g., *In re Drexel Burnham Lambert Group*, No. 90-B-10421 (Bankr. S.D.N.Y. Feb. 13, 1990) (order classifying postpetition indemnity claims as administrative expense claims). See also *In re Heck's Properties, Inc.*, 151 B.R. 739, 766-768 (S.D. W. Va. 1992) (reviewing related case law and allowing indemnification of directors and officers "related solely to post-petition conduct and services").

(n50)Footnote 50. See 11 U.S.C. § 548. Recent amendments to Section 548 may further limit the usefulness of such trusts. In particular, new Section 548(e), which was added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, effective in cases commenced on or after October 17, 2005, provides that:

the trustee may avoid any transfer of an interest of the debtor in property that was made on or within 10 years before the date of the filing of the petition if--(A) such transfer was made to a self-settled trust or similar device; (B) such transfer was by the debtor; (C) the debtor is a beneficiary of such trust or similar device; and (D) the debtor made such transfer with actual intent to hinder, delay, or defraud any entity to which the debtor was or became, on or after the date that such transfer was made, indebted.

11 U.S.C. § 548(e)(1) (emphasis added).

The section further provides that the term "transfer" includes a transfer made in anticipation of any money judgment, settlement, civil penalty, equitable order, or criminal fine incurred by, or which the debtor believed would be incurred by any violation of the federal or state securities laws or fraud, deceit, or manipulation in a fiduciary capacity or in connection with the purchase or sale of any security registered under section 12 of 15(d) of the Securities Exchange Act of 1934 or under section 6 of the Securities Act of 1933. 11 U.S.C. § 548(e)(2).

(n51)Footnote 51. See 11 U.S.C. § 548(a)(1)(B)(i). (The Religious Liberty and Charitable Donation Protection Act of 1998 defines circumstances under which a transfer of a charitable contribution to a qualified religious or charitable institution will not be considered a fraudulent transfer. The Act also prohibits the trustee from avoiding these charitable contributions when acting as lien creditor and successor to certain creditors and purchasers.)

The trust may also be subject to attack as an avoidable preferential transfer if the trust was established within one year prior to the filing of the bankruptcy petition and while the corporation was insolvent. See 11 U.S.C. § 547(b).

(n52)Footnote 52. See ns.30-33 and accompanying text *supra*.

(n53)Footnote 53. See n.49 and accompanying text *supra*.

(n54)Footnote 54. *Del. Code Ann. tit. 8, § 145(g)*.

(n55)Footnote 55. Although D&O policy exclusions vary, common exclusions include the following: (i) bodily injury and property damage liability; (ii) ERISA liability; (iii) environmental liability; (iv) deliberate fraud; (v) nuclear hazards; (vi) personal profit or advantage; (vii) Section 16(b) of the Securities and Exchange Act (short-swing trading); and (viii) libel and slander. See generally D. Block, S. Barton & S. Radin, *The Business Judgment Rule: Fiduciary Duties of Corporate Directors and Officers*, 2030-31 (5th ed. 1998). Although not a D&O exclusion, the D&O carrier may decline to provide coverage if there is other insurance available to cover the claim. See *id.* at 2039.

(n56)Footnote 56. The insolvency of the insurer may trigger state "guaranty funds" which will generally pay claims up to certain statutory limits.

(n57)Footnote 57. See, e.g., *In re A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1001, 15 C.B.C.2d 235, 244-45 (4th Cir. 1996) (finding insurance contracts to be property of the bankruptcy estate pursuant to section 541 of the Bankruptcy Code); *In re Minoco Group of Cos.*, 799 F.2d 517, 519, 15 C.B.C.2d 1277, 1279 (9th Cir. 1986) ("liability policies meet the fundamental test of whether they are 'property of the estate' because the debtor's estate is worth more with them than without them").

(n58)Footnote 58. See, e.g., *Louisiana World Exposition, Inc. v. Federal Ins. Co. (In re Louisiana World Exposition)*, 832 F.2d 1391, 1399 (5th Cir. 1987) ("The question is not who owns the policies, but who owns the liability proceeds."); *In re Adelphia Communications Corp.*, 298 B.R. 49, 53-54 (S.D.N.Y. 2003) (holding that when a corporation has not yet made any indemnification payments it has "no cognizable equitable and legal interest in the proceeds from the D&O policies" such that the "estate cannot be ascribed to hold a property interest in those proceeds"); *Miller v. McDonald (In re World Health Alternatives, Inc.)*, 2007 WL 1670357, * 4-5 (Bankr. D. Del. 2007) (concluding that insurance proceeds are not property of the debtor's estate where "wasting" insurance policy covered the debtor and its directors and officers, and there was no risk that payment of the proceeds to directors would reduce the debtor's policy coverage). But see *In re Sacred Heart Hosp.*, 182 B.R. 413 (Bankr. E.D. Pa. 1995) (holding that, where D&O policy provided contemporaneous coverage for the debtor and its directors and officers, the policy proceeds were part of the bankruptcy estate).

(n59)Footnote 59. The automatic stay prevents any lawsuits from being instituted against the debtor company postpetition, and prevents further prosecution of prepetition lawsuits absent court ordered relief from the stay. See section 362(a)(1). Non-debtor defendant directors and officers are not usually protected by the stay, even as co-defendants. See 3 *Collier on Bankruptcy*, P 362.03[3][d] (Matthew Bender 15th Ed. Revised). A court "retains the power to enjoin the action if continuation of the action would interfere substantially with the debtor's reorganization." *Id.* See also *In re A.H. Robins Co. v. Piccinin*, 788 F.2d at 1008, 15 C.B.C.2d at 252-53 (affirming a preliminary injunction staying suits against the debtor and its co-defendants pursuant to sections 105 and 362 of the Bankruptcy Code, and noting that "if the suits are permitted to continue and discovery allowed, any effort at reorganization of the debtor will be frustrated, if not permanently thwarted"); *In re Johns-Manville Corp.*, 10 C.B.C.2d 643, 40 B.R. 219 (S.D.N.Y. 1984) (affirming bankruptcy court decision enjoining litigation against employee co-defendants).

(n60)Footnote 60. See, e.g., *In re Adelphia Commc'ns Corp.*, 298 B.R. 49, 53-54 (S.D.N.Y. 2003) ("Without legal and equitable interest in the proceeds, [the bankruptcy] estate cannot be ascribed to hold a property interest in those proceeds"); *In re CHS Elecs., Inc.*, 261 B.R. 538, 541-42 (Bankr. S.D. Fla. 2001) (holding that, "where the debtor owns the policies but has no interest in the proceeds, the proceeds are not property of the estate").

(n61)Footnote 61. See, e.g., *In re Enron Corp.*, Case No. 01-16034 (AJG) (Bankr. S.D.N.Y. April 11, 2002) (transcript of hearing at 15) (allowing advancement of defense costs to directors and officers, where the policy in question earmarked a special fund for such costs).

(n62)Footnote 62. *See, e.g., In re Lernout & Hauspie Speech Prods. N.V.*, Case Nos. 00-4397 through 00-4399 (JHW) (Bankr. D. Del. May 8, 2001) (hearing transcript at 44, 48-49) (allowing advancement of defense costs to beneficiary directors and officers who, pursuant to the terms of the D&O policy, had a priority interest in its proceeds).

(n63)Footnote 63. *See, e.g., In re Minoco Group of Cos.*, 799 F.2d 517, 518-19, 15 C.B.C.2d 1277, 1278-79 (9th Cir. 1986) (affirming decision that enjoined insurer from canceling debtor's insurance policies upon judicial determination that insurance policies are property of the bankruptcy estate, and thus subject to the automatic stay). However, a stay is possible even if the insurance policies are not part of the bankruptcy. *See In re Adelphia Commc'ns Corp.*, 298 B.R. 49, 54 (S.D.N.Y. 2003) (holding that "the fact that the stay under 11 U.S.C. § 362(a)(3) may not apply automatically does not render the Bankruptcy Court's decision to stay litigation...necessarily subject to reversal.")

(n64)Footnote 64. Although the policy itself may be property of the estate and thus subject to the stay, D&O policy proceeds are not necessarily property of the estate. *See* n.57 *supra*.

(n65)Footnote 65. *See, e.g., In re Enron Corp.*, Case No. 01-16034 (AJG), (Bankr. S.D.N.Y. April 11, 2002) (transcript of hearing at 16) (finding that entity coverage implicates the stay, and finding cause to lift the stay and grant the debtors and their directors and officers the ability to exercise their contractual rights against the debtors' fiduciary policies); *In re Just for Feet, Inc.*, Case No. 99-4110 (MFW), (Bankr D. Del. Oct. 3, 2001) (terminating, annulling and lifting automatic stay, to the extent applicable, to allow advancement of defense costs with respect to proceeds of the debtors' directors' and officers' policy); *In re Lernout & Hauspie Speech Prods. N.V.*, Case Nos. 00-4397 through 00-4399 (JHW) (Bankr. D. Del. May 8, 2001) (granting, to the extent applicable, relief from stay to permit advancement of defense expenses to debtors' directors and officers, subject to carrier's reservation of rights under the policy and at law).

(n66)Footnote 66. *See, e.g., N.Y. Ins. Law* § 3426.

(n67)Footnote 67. 799 F.2d 517, 15 C.B.C.2d 1277 (9th Cir. 1986) .

(n68)Footnote 68. *See id. at 519* . *See also In re A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 1001, 15 C.B.C.2d 235, 244-45 (4th Cir. 1986) ("[a] products liability policy of the debtor ... may well be ... 'the most important asset of [i.e., the debtor's] estate' ") (citing *In re Johns-Manville Corp.*, 10 C.B.C.2d 643, 654, 40 B.R. 219, 229 (S.D.N.Y. 1984)) ; *In re Louisiana World Exposition*, 832 F.2d at 1399 (citing cases for the proposition that insurance policies belong to the bankruptcy estate); *In re Johns-Manville Corp.*, 10 C.B.C.2d 643, 656, 40 B.R. 219, 230 (S.D.N.Y. 1984) ("[T]he fact that it ultimately may not receive all of the proceeds under its products liability insurance does not affect its status as property under the Code subject to the provisions of the automatic stay.").

(n69)Footnote 69. *See 11 U.S.C. § 548*.



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CHAPTER 3 The Board of Directors in a Workout

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P 3.06 Remaining With the Debtor Company Through the Reorganization Process.

It doubtless seems that potential liability for directors and officers is endless. Directors and officers of bankrupt business entities may thus wonder whether it is worthwhile to remain involved with the company during the reorganization process. There are often, however, substantial benefits to remaining with the reorganizing entity or entities, and little, if any, risk of additional liability.

First, resigning one's position will not absolve the director or officer from liability resulting from actions taken prior to the effective date of the resignation. Conversely, during the reorganization process, the likelihood of incurring additional exposure is limited. During the pre-filing restructuring, decisions of the board and management are subject to greater scrutiny. Informal committees representing various creditor constituencies review most material decisions. Sometimes the consent of these constituencies may be required by the applicable agreements. After a bankruptcy filing, the bankruptcy court provides additional oversight. Decisions made outside the ordinary course of business generally require approval of the bankruptcy court.ⁿ¹ While the Bankruptcy Code grants the debtor in possession the ability to sell certain of the company's assets,ⁿ² or to reject an economically unfriendly contract,ⁿ³ these actions cannot be consummated absent proper notice to the court and parties in interest.ⁿ⁴ The court will review the terms of the proposed transaction, generally using a business judgment standard.ⁿ⁵ Absent some fraud upon or lack of disclosure to the court, it is unlikely a bankruptcy court would find directors liable for damages arising from a transaction the court itself approved.

By remaining with the company, directors and officers can move the restructuring forward toward a consensual resolution. Although the debtor's discharge does not operate to discharge such directors and officers,ⁿ⁶ in a consensual restructuring, the debtors and other parties may be willing to grant releases from liability to the directors and officers who have taken an active role in accomplishing a reorganization.ⁿ⁷

FOOTNOTES:

(n1)Footnote 1. *See, e.g., section 363(b)(1) of the Bankruptcy Code* ("The trustee [or debtor in possession], *after notice and a hearing*, may use, sell, or lease, other than in the ordinary course of business, property of the estate.") (emphasis added).

(n2)Footnote 2. *See section 363 of the Bankruptcy Code.*

(n3)Footnote 3. *See section 365 of the Bankruptcy Code.*

(n4)Footnote 4. *See 3 Collier on Bankruptcy, P 363.02[1][f]* (Matthew Bender 15th Ed. Revised) ("In determining whether to approve a proposed sale under section 363, courts generally apply standards that, although stated variously [sic] ways, represent essentially a business judgment test.").

(n5)Footnote 5. *See sections 363 and 365 of the Bankruptcy Code* (each requiring the court's approval prior to any action by the trustee or debtor in possession).

(n6)Footnote 6. *See section 524(e) of the Bankruptcy Code* (discharge of the debtor does not affect the liability of any other entity on such debt); *Gillman v. Cont'l Airlines, Inc. (In re Cont'l Airlines)*, 203 F.3d 203, 211 (3d Cir. 2000) ("the bankruptcy discharge of a debtor, by itself, does not operate to relieve non- debtors of their liabilities").

(n7)Footnote 7. Although some courts have held that plan provisions that purport to release claims of creditors against non-debtors are per se invalid, there are grounds for upholding consensual release, particularly if the released party provides consideration in exchange for the release, or "the injunction plays an important part in the debtor's reorganization plan." *Securities & Exch. Comm'n v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 960 F.2d 285, 293, 26 C.B.C.2d 1413, 1422 (2d Cir. 1992) . *See also In re Zenith Elecs. Corp.*, 43 C.B.C.2d 206, 241 B.R. 92 (Bankr. D. Del. 1999) . *In re Master Mortgage Inv. Fund, Inc.*, 31 C.B.C.2d 240, 247-48, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994) (articulating factors that the court may consider in considering approval of reorganization plan containing releases of non-debtor third parties).



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CHAPTER 3 The Board of Directors in a Workout

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P 3.07 The Sarbanes-Oxley Act of 2002.

[1] Generally.

The enactment of The Sarbanes-Oxley Act (the "SOA") in 2002 brought forth broad corporate governance and accounting reform, including amplified disclosure requirements and increased accountability of officers, directors, accountants, and attorneys.ⁿ¹ While much literature has been generated on the intricacies of the impact of the SOA on solvent companies, the SOA's effect on troubled companies in bankruptcy is not yet fully known. However, the SOA does not contain any exemption for chapter 11 debtors, leaving officers and directors of debtors (and their counsel) in murky waters. This discussion of the SOA is not intended as a treatise on the SOA but rather a description of the interplay between the SOA and bankruptcy as relevant to officers and directors of distressed companies.

[2] Crackdown on Fraud.

In addition to increasing the criminal penalties of existing securities laws, the SOA erased all uncertainty regarding the lack of dischargeability of debts arising from securities law violations with respect to individual debtorsⁿ² and added to title 18 of the U.S.C. a bankruptcy crime.ⁿ³

Under *18 U.S.C. § 1519*, it is a federal crime if a person "knowingly alters, destroy, mutilates, conceals, covers up, falsifies or makes a false entry in any record, document or tangible object with the intent to impede, obstruct or influence ... any case filed under title 11, or in relation to or contemplation of any such matter or case." While intent is an element of section 1519 and, therefore, a director or officer cannot accidentally run afoul of the new crime, its addition in the SOA makes clear Congress's effort to crack down on bankruptcy fraud. Further evidence of the increased concern regarding the integrity of the bankruptcy process is the U.S. Trustee Program's newly-created Criminal Enforcement Unit whose sole charge is to prosecute bankruptcy crimes. Directors and officers of chapter 11 debtors should be aware of this "crackdown" and act and supervise employees accordingly.

[3] Reporting Requirements.

As stated above, the SOA does not contain an exemption for chapter 11 debtors, indicating that companies subject to the SOA's reporting requirements do not shed those obligations upon the filing of a bankruptcy case. What is not clear, however, is (i) whether or how a debtor may file modified forms of disclosure, as permitted by the SEC for companies filing under the Securities Exchange Act of 1934 ("34 Act") and (ii) whether compliance with the SOA while in

bankruptcy is practicable for most debtors.

While public companies are not relieved of their '34 Act reporting obligations by filing a chapter 11 petition, historically debtors have been able to modify their reporting obligations while in bankruptcy pursuant to the Securities and Exchange Commission's Release 34-9660 (June 30, 1972) and Staff Legal Bulletin Number 2 (April 16, 1997). In Release 34-9660, the SEC stated that it would allow modified reporting under certain circumstances. Factors to be considered are (i) how frequently the debtor's securities are trading, (ii) the reason for the debtor's request and (iii) whether modified reporting will adequately protect the debtor's investors. If specific permission is desired, a debtor may also request a no-action letter regarding modified reporting. Debtors choosing to modify their reporting should be diligent in informing their investors of any material matters in the case, as mandated by the monthly reports required by the bankruptcy court. While prior to the enactment of the SOA debtors were comfortable complying with the SEC's requirements, the SEC has not yet provided guidance on whether past practice is permissible under the SOA.

While determining the required type of reporting is difficult, attempting to comply with the SOA in bankruptcy may be impossible or impracticable for some debtors. For example, a company's bankruptcy filing or entry into the vicinity of insolvency frequently causes a change in senior management. The exit of executives may render a corporation unable to file certified financial statements. Even debtors who are able to abide by the SOA may find such compliance to be unduly burdensome, either due to the cost of disclosure and other compliance or the time required to adequately ensure observance.

[4] Director and Officer Liability.

One near certainty in this evolving area of law is that the SOA will contribute to the rising popularity of suits by creditors against directors and officers of troubled companies. The complexities of strict compliance with the SOA combined with increased accountability and officer certifications will likely make claims against directors and officers increasingly attractive to creditors seeking recovery from D&O insurance policies.

FOOTNOTES:

(n1)Footnote 1. The Sarbanes-Oxley Act of 2002, 107 H. R. 3763 (2002).

(n2)Footnote 2. 11 U.S.C. § 523(a). See *In re Chan*, 355 B.R. 494, 503 (Bankr. E.D. Pa. 2006) (noting that judgments and settlements based on securities law violations are nondischargeable pursuant to section 523(a)(19) of the Bankruptcy Code, in order to protect victimized investors' ability to recover their losses); *Frost v. Civiello* (*In re Civiello*), 348 B.R. 459, 467 (Bankr. N.D. Ohio 2006) (same).

(n3)Footnote 3. 18 U.S.C. § 1519.



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CHAPTER 4 Representing the Lender

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CHAPTER 4 Representing the Lender

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P 4.01 Introduction.

A lender to a troubled company confronts an array of complex, and sometimes contradictory, tasks in assessing and minimizing its credit risk. The lender must have a thorough understanding of the borrower's financial condition and chances for remaining a viable operating entity as well as the ability of the borrower's management to deal with the crisis at hand and lead the borrower to recovery. The lender must also analyze the strengths and weaknesses of the borrower's other constituencies, including other creditors, governmental agencies, suppliers and employees.

In addition, the prudent lender must consider its own vulnerabilities, including the risk of lender liability. The issue of lender liability has loomed larger for the lender and its advisors due in part to a series of multi-million dollar awards against banks that lent money to companies that foundered. Initially, some decisions appeared, on first blush, to expand significantly the liability of commercial lenders and financiers,ⁿ¹ but most lawsuits have turned more on particular facts than on any sweeping changes in the law.

FOOTNOTES:

(n1)Footnote 1. *E.g.*, *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985) ; *State Nat'l Bank of El Paso v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. Ct. App. 1984) ; *but cf. Fasolino Foods Co. v. Banca Nazionale del Lavoro*, 961 F.2d 1052, 1057-58 (2d Cir. 1992) (limiting lenders liability to circumstances where lender represented that credit of a certain amount would be provided).



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CHAPTER 4 Representing the Lender

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P 4.02 Scope and Use of This Chapter.

The purpose of this chapter is to give the lender the tools to answer the key questions it faces when its borrower encounters financial difficulties. Those tools include the scope and content of the due diligence review that should be performed at the outset of any workout. This chapter describes the type of due diligence a lender should conduct, including basic financial information, the status of security interests and collateral, the effect of subordination provisions and other important considerations.

In addition, the lender and its advisors must be well-versed in the law of lender liability. Lender liability is a conglomerate of theories borrowed from other areas of the law and adapted to the debtor-creditor relationship. Since no single legal rubric embraces the many theories of lender liability that have emerged, this chapter addresses several of the main theories. The legal theories that a lender should consider include the obligation of good faith and fair dealing, the common law theories of fraud, interference and excessive control/alter ego, and the bankruptcy theories of fraudulent conveyance, aiding and abetting a breach of fiduciary duty and equitable subordination. Because the application of lender liability theories turns heavily on particular facts, several noteworthy cases are examined in detail to identify more precisely the contours of the law.

Armed with an understanding of the law, the lender should be able to assess its exposure at the start of a workout, navigate safely through the workout and participate in a restructuring that does not result in new liability. Even when an out-of-court restructuring is feasible, bankruptcy law considerations are useful to bear in mind because such considerations can provide an incentive for negotiations and a baseline for assessing how a lender would fare absent a successful workout.



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CHAPTER 4 Representing the Lender

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P 4.03 Initial Due Diligence Investigation by the Lender.

At the beginning of a restructuring, a lender must investigate its borrower's financial condition and examine any facts that may affect the lender's own vulnerability. This section describes the initial due diligence that a lender should conduct when it determines that its borrower is in financial difficulty.

[1] Collateral.

If the lender has the benefit of collateral securing its debt, it should confirm that it holds a validly perfected security interest under applicable state law. This analysis involves a review of the state law requirements for the creation and perfection of security interests.

In most cases, a security interest is perfected by the filing of a real estate mortgage or Uniform Commercial Code ("UCC") financing statement. In such instances, the lender must determine whether all proper federal, state and local filings (including, if appropriate, UCC continuation statements) have been made and still appear of record. Such filings are necessary to protect the lender's interest against subsequent creditors and against the bankruptcy trustee. In other instances, as in the case of certificated securities, a security interest may only be perfected by possession of the collateral rather than through the filing of a financing statement or similar document. In such instances, the lender should make certain that it has possession of the collateral.

Where the security interest is unperfected, the lender should consider taking steps to correct the problem. If proper filings were not made in the first instance, such filings should be made as soon as a problem is detected. In addition, even where appropriate filings have been made, the lender should confirm that the filings are in proper order. The UCC provides, in general, that a valid financing statement must contain only (i) the name of the debtor, (ii) the name of the creditor, and (iii) a statement indicating the collateral.ⁿ¹ However, a serious defect can be fatal to the lender's interests and a prudent lender will want to take any prophylactic actions necessary to correct filings without delay, since such prophylactic filings may be construed as preferences in the event of a subsequent bankruptcy.ⁿ²

Second, a secured lender should attempt to ascertain whether any other creditors have competing claims against its collateral and, if so, the extent and priority of those claims. The development of this information will usually require the lender to conduct lien or UCC searches in a number of jurisdictions. As a consequence, the lender should try to consult with the borrower prior to making any search to determine whether the borrower has ever changed its corporate name or

place of organization and whether the borrower in fact owns the collateral.ⁿ³ Other valuable sources of such information include public filings, auditors' reports, credit reports and company histories. Additionally, certain interests, like possessory security interests, need not be recorded to become perfected, so the lender should determine who is in possession of the property. A simple physical examination of the collateral will suffice, but the lender may also seek some written representation from the borrower as to whether such interests exist.

The third inquiry of a secured lender will focus on the value of its collateral. Because postpetition interest is generally payable under the Bankruptcy Code only to the extent that the underlying claim is oversecured, a secured lender will want to know the effect of bankruptcy on the current yield on its debt.ⁿ⁴ A lender that is comfortably oversecured will be less concerned about the risk of bankruptcy than one who is not. When seeking an appraisal of the assets securing its debt, a lender should do so in a manner that increases the potential for immunity from compelled disclosure as attorney work-product in the event that the result of the appraisal is disappointing. Ideally, this requires that counsel engage the appraiser, that the work be done in anticipation of litigation, and that the lender not disclose the results of the appraisal to other parties.

Finally, bank lenders should investigate the availability of setoff rights against the troubled borrower pursuant to *section 553 of the Bankruptcy Code*.ⁿ⁵ Such rights are available only to lenders holding deposits, and only when payment is due. Setoff rights, if they are to be used at all, may be better used sooner rather than later, since the borrower might move the deposit prior to filing for bankruptcy if it is not otherwise restricted by a compensating balance or similar agreement. However, it may be advantageous to the bank lender to forebear from exercising a right of setoff. A lender exercising setoff prior to bankruptcy may have to disgorge a portion of the funds to the extent balances were increased in the 90 days prior to bankruptcy while a lender that lets the balances remain undisturbed will generally be entitled to a security interest in the entire amount.ⁿ⁶

[2] Flow of Information.

In assessing the prospects of a successful out-of-court restructuring, a lender needs the best possible information on the financial health of the borrower's business, including information concerning the borrower's projected cash flow and ability to service debt. The lender will also seek to determine whether the borrower's management is capable of functioning effectively to manage the situation, or whether new managers (either temporary crisis managers or full-time replacements for existing management) should be engaged to help the borrower steer its course successfully to recovery. To ensure that it has good information, a lender may request that the borrower underwrite the cost of a financial advisor to assist in the analysis and may seek access to the borrower's own financial advisor for information (if not advice). The lender should stay in close touch with management to keep abreast of current developments and to monitor performance. Management that is open and cooperative in response to the lender's concerns will, of course, inspire more confidence than management that is evasive and inaccessible.

[3] Other Liabilities of the Borrower.

A central focus of any lender's due diligence will be the liability side of its borrower's balance sheet. To properly assess its positions and strategy, a lender must be familiar with the amount, priority and nature of the borrower's other obligations and their impact on the ability to successfully restructure the borrower. This section focuses on potential tax, pension obligations and other employee benefits, and environmental liabilities because the potential magnitude and special legal nature of those liabilities often render them difficult to restructure.

[a] Liability for Taxes.ⁿ⁷

A lender should carefully evaluate its borrower's current and potential tax obligations. The Internal Revenue Code imposes income, withholding and excise tax, and wage withholding obligations on certain corporations.ⁿ⁸ Tax obligations of a borrower will be affected by whether it is a member of a federal affiliated groupⁿ⁹ because each

member of such group may be held liable for the tax liability of the entire group.ⁿ¹⁰ Where liability may be imposed on a borrower, a lender should determine the likelihood that interest and penalties will be imposed.ⁿ¹¹

Generally, the Internal Revenue Service must assess any federal tax liability within three years of filing of the return to which the assessment relates.ⁿ¹² In cases where there has been an understatement of gross income in excess of 25 percent, a six-year statute of limitations applies.ⁿ¹³ In the case of a fraudulent return or the failure to file any return, there is no statute of limitations.ⁿ¹⁴

The Internal Revenue Code provides that if any person liable to pay a tax fails to pay that tax, a lien in favor of the United States is created with respect to all of that person's property and rights to property.ⁿ¹⁵ This federal tax lien generally continues in effect until the liability is satisfied.ⁿ¹⁶ As with certain other liens, an unperfected federal tax lien is not effective as against any good faith purchaser, holder of security interest, mechanic's lienor or judgment lien creditor.ⁿ¹⁷ A federal tax lien is only effective as against such third parties if the tax lien is perfected by filing notice of the lien pursuant to applicable state law requirements.ⁿ¹⁸ The priority of a federal tax lien is generally governed by the "first in time, first in right" principle.ⁿ¹⁹ The Internal Revenue Code also provides that a perfected tax lien generally has priority over secured and unsecured creditors with respect to property the debtor acquires after the tax lien is perfected.ⁿ²⁰ This priority over after-acquired property is particularly significant for floating lien financings that are secured by accounts receivable or inventory.

A lender should check both U.C.C. filings and filings with the county recorder's office to determine whether a tax lien has been filed against the borrower. In addition, a lender should request an undertaking by the borrower to notify the lender (i) in the event it fails to pay taxes when due, (ii) upon the receipt of any tax assessment and (iii) upon the recording of any tax lien against its assets. Furthermore, a lender should consider requesting the right to seize its collateral upon the filing of a federal tax lien against the borrower.

The treatment of an unperfected federal tax lien in the bankruptcy of a borrower depends upon the nature of the tax involved and the period to which it relates. In general, unperfected tax liens are treated as either first, second or eighth priority claims in bankruptcy.ⁿ²¹

The treatment of a perfected tax lien in a title 11 case depends upon whether the borrower is undergoing a reorganization under chapter 11 or a liquidation under chapter 7. In a chapter 11 case, the perfected tax lien will be a secured claim against the assets of the debtor.ⁿ²² However, in a chapter 7 case, perfected federal tax liens are subordinated to administrative and priority unsecured claims.ⁿ²³

Special rules apply in the case of so-called "trust fund" taxes. Trust fund taxes, which a company is required to collect or withhold from another person and pay over to the United States, include income taxes and FICA taxes that are withheld from the salaries of employees of the company. The amount of such trust fund taxes that the company withholds or collects is treated as a "special fund in trust for the United States."ⁿ²⁴ As a result, amounts that the company had withheld as trust fund taxes are not part of the debtor's estate under *section 541(a) of the Bankruptcy Code* and, therefore, the total amount available to satisfy creditors' claims will be reduced by such amounts.ⁿ²⁵

In addition to reviewing potential federal tax liabilities, the lender should analyze the effect of applicable state and local tax rules. The treatment of state and local tax liabilities is beyond the scope of this section. In addition, *Section 6672(a) of the Internal Revenue Code* provides that any person responsible for collecting, truthfully accounting for and paying over trust fund taxes who willfully fails to fulfill these responsibilities will be subject to a penalty equal to the amount of such taxes. As a result, company officers and directors may be personally liable for trust fund taxes.ⁿ²⁶

[b] Liability for Pension Obligations and Other Employee Benefits.

The lender should pay special attention to a borrower's unfunded "defined benefit"ⁿ²⁷ pension plan liabilities. Both the

Internal Revenue Code and ERISA establish funding requirements for such plans and provide for the creation of liens on the property of, and the imposition of excise taxes on, the plan sponsor and members of its "controlled group" if funding obligations are not met. In particular, failure of an underfunded plan's sponsor to meet ongoing quarterly and annual minimum funding requirements gives rise to a lien on the assets of the sponsor and all members of its "controlled group" if the unpaid amounts exceed \$1,000,000.ⁿ²⁸ The lien arises on the due date of the payment.ⁿ²⁹ In addition, if the plan sponsor fails to satisfy the minimum funding requirements (or to obtain a waiver in accordance with the applicable provisions of the Internal Revenue Code) for a particular plan year, the plan sponsor and all members of its controlled group will be jointly and severally liable for certain excise taxes imposed in connection with such failure.ⁿ³⁰

Although the federal Pension Benefit Guaranty Corporation ("PBGC") guarantees pension benefits in the event of the termination of an underfunded defined benefit pension plan, ERISA limits a plan sponsor's ability to extinguish and/or transfer liabilities to the PBGC through termination of the plan. An underfunded plan cannot be voluntarily terminated by a plan sponsor unless the sponsor and each member of its controlled groupⁿ³¹ (1) are in liquidation or reorganization under the Bankruptcy Code or similar state law,ⁿ³² or (2) demonstrate to the PBGC's satisfaction that they will be unable to continue in business and pay their debts when due absent the termination (or that the costs of providing pension coverage have become unreasonably burdensome solely as a result of the decline of the company's work force).ⁿ³³ If these "distress termination" criteria are met, the plan can be terminated,ⁿ³⁴ but the sponsor (and the other members of its controlled group) will nonetheless be liable for all unfunded benefits accrued under the plan as of the plan's termination date.ⁿ³⁵ Upon plan termination, the PBGC will be entitled to a lien on all assets of the controlled group members, up to the lesser of the unfunded liability and 30% of the group's collective net worth; the remainder of the liability will generally be an unsecured obligation.ⁿ³⁶ Further, the lender should also consider that the PBGC can initiate a plan termination under certain circumstances (thereby triggering liability for the full amount of the underfunding and the imposition of a lien), and in fact must do so whenever it determines that a plan does not have enough assets to pay liabilities that are currently due under the terms of the plan.ⁿ³⁷

The Internal Revenue Code and ERISA provide that the lien for unpaid minimum funding contributions and the lien imposed on underfunded terminated plans are both treated as federal taxes due and owing, signaling that priority for such liens is governed by the Internal Revenue Code.ⁿ³⁸ However, several courts have held that these pension plan related liens are not afforded tax lien priority under the applicable sections of the Bankruptcy Code.ⁿ³⁹ Instead, these courts have held that the Bankruptcy Code governs priority and, therefore, do not assign tax priority to the entire amount of the PBGC liens.ⁿ⁴⁰

If a borrower is obligated to contribute to any "multiemployer plan,"ⁿ⁴¹ the lender should also be mindful that a restructuring program that involves scaling down operations may trigger "withdrawal liability" for the borrower. Withdrawal liability is an allocation of a portion of the entire plan's unfunded liabilities, which may be triggered when an employer ceases or reduces significantly its contributions to the plan.ⁿ⁴² Although there are no special statutory lien provisions for the enforcement of withdrawal liability obligations, the amounts of withdrawal liability assessed can be significant.

Finally, because ERISA's minimum funding liability, lien provisions, and excise tax law apply not only to sponsoring employers but also to other members of their controlled groups, lenders should be alert for signs of distress on the part of a borrower's related companies, even if the borrower's own financial condition appears sound.

[c] Liability Under CERCLA.ⁿ⁴³

The lender will want to perform environmental due diligence if there is a possibility that the troubled company could have any environmental liabilities or obligations. These liabilities and obligations could be triggered by the company's failure to comply with environmental laws or by releases of hazardous materials at the facilities owned or operated by the company.

The financial impact of environmental laws, such as the Comprehensive Environmental Response, Compensation, and Liability Act of 1980 ("CERCLA"),ⁿ⁴⁴ may be acutely felt by an already-troubled company to the detriment of its lenders. First, costs associated with environmental liabilities and obligations, including amounts required for environmental cleanup efforts and civil and criminal fines, can directly impair the ability of the company to make its debt payments. In addition, the presence of hazardous substances on property can diminish the value of a lender's collateral. Environmental costs may be particularly significant for a lender because bankruptcy may not be a fail-safe way to stay government actions concerning environmental cleanup,ⁿ⁴⁵ and cleanup costs may have administrative expense priority over other debts in bankruptcy.ⁿ⁴⁶ A lender must be concerned with whether environmental obligations are dischargeable in bankruptcy, what the priority of such claims will be and the impact of such claims on the lender. As noted by one court, "[t]he intersection of environmental cleanup laws and federal bankruptcy statutes is somewhat messy."ⁿ⁴⁷ The dischargeability issue often achieves prime importance. If an environmental cleanup cost claim is not discharged, it will survive the bankruptcy and the reorganized debtor will continue to bear the liability for cleanup costs. If it is discharged, those costs will be left to third parties or the public.

A lender should not get overly involved in the affairs of the debtor's organization because the lender could incur liability under CERCLA or other environmental laws. A lender could forfeit its right to the protections provided to secured creditors under CERCLA if it exercises control similar to that of a manager or exercises decision making control over the environmental compliance of a facility.ⁿ⁴⁸

[i] Priority of Environmental Cleanup Costs.

In *In re Chateaugay Corp.*, the Court of Appeals for the Second Circuit viewed postpetition cleanup costs incurred by the Environmental Protection Agency (the "EPA") with respect to property still owned by a debtor as administrative priority claims because the EPA was acting during the administration of the estate to remedy on-going effects of a release and threatened release of hazardous substances.ⁿ⁴⁹

Although many state environmental liens do not take priority over prior recorded liens, a number of state "superlien" statutes place environmental liens above all or most prior liens.ⁿ⁵⁰ Satisfaction of "superliens" can leave a troubled company without sufficient assets to make payments to even its senior debt holders.

[ii] Dischargeability of CERCLA Claims.

Under the Bankruptcy Code, a debt is a liability on a claim.ⁿ⁵¹ *Section 101 of the Bankruptcy Code* defines claim very broadly.ⁿ⁵²

The broad definition of a "claim" and the requirement that all claims be timely filed are intended to allow the bankruptcy court to determine whether a proposed plan of reorganization is fair to all creditors.

On the other hand, CERCLA's strict liability provisions are intended to protect the environment by distributing cleanup costs widely to ensure payment.

In determining whether a claim is dischargeable under a plan of reorganization, courts have struggled with the competing goals of protecting the public health and the environment and permitting a debtor a fresh start after discharge.ⁿ⁵³

In *In re Chateaugay Corp.*, the Court of Appeals for the Second Circuit stated its support for the Bankruptcy Code, finding that "[i]f the [Bankruptcy] Code, fairly construed, creates limits on the extent of environmental cleanup efforts, the remedy is for Congress to make exceptions to the [Bankruptcy] Code to achieve other objectives that Congress chooses to reach...".ⁿ⁵⁴ That court, relying on the argument that a "'claim' should be deemed to exist whenever, in the absence of bankruptcy, a particular claimant has the right to reach the debtor's assets,"ⁿ⁵⁵ disagreed with the EPA's

contention that a claim arises when the EPA incurs response costs.ⁿ⁵⁶ The Second Circuit instead held that a CERCLA claim arises upon the release or threatened release of hazardous wastes.ⁿ⁵⁷ Such a contingent claim for response costs to be incurred in the future may be estimated pursuant to *section 502(c) of the Bankruptcy Code*.

That case has been criticized for so broadly defining "claim" as to "encompass costs that could not 'fairly' have been contemplated by the EPA or the debtor pre-petition."ⁿ⁵⁸

Some courts have articulated a rule that a CERCLA claim does not arise until a party incurs response costs.ⁿ⁵⁹ Commentators have criticized such a rule on the basis that it "ignore[s] the fact that parties are often required to file contingent claims ... [and] gives the creditor too much control over the accrual of its claim."ⁿ⁶⁰

The Seventh Circuit has taken an intermediate position and decided that

"[w]hen a potential CERCLA claimant can tie the bankruptcy debtor to a known release of a hazardous substance which the potential claimant knows will lead to CERCLA response costs, and when this potential claimant has, in fact, conducted tests with regard to this contamination problem, then this potential claimant has, at least, a contingent CERCLA claim," which may be discharged.ⁿ⁶¹

In *In re National Gypsum Co.*,ⁿ⁶² the court found that a CERCLA claim in bankruptcy relates to costs associated with a release or threat of release that could have been "fairly" contemplated by the parties.ⁿ⁶³ The *National Gypsum* court stated that among the indicia of "fair contemplation" was "knowledge by the parties of a site in which a [potentially responsible party] may be liable, [National Priorities List] listing, notification by EPA of [potentially responsible party] liability, commencement of investigation and cleanup activities, and incurrence of response costs."ⁿ⁶⁴ In determining whether a private claimant had sufficient notice, a court may examine whether the subsequent purchaser was aware of releases of hazardous material at the site, whether the environmental risks played any role in the determination of the purchase price, whether the subsequent purchaser contemplated future suit against the debtor, and whether prior to bankruptcy the parties considered the site an environmental risk.ⁿ⁶⁵

[iii] CERCLA Orders That Are Not Dischargeable.

The Court of Appeals for the Seventh Circuit in *In re CMC Heartland Partners* ⁿ⁶⁶ distinguished certain actions by the EPA under CERCLA that may be pursued following confirmation of a plan of reorganization. That litigation was triggered by the EPA's order, under Section 106 of CERCLA, that CMC Heartland Partners ("CMC") and General Motors cleanup a sludge dumping site. CMC argued that the EPA's order violated the injunction issued by the bankruptcy court for the Northern District of Illinois at the end of CMC's predecessor's bankruptcy case. The Seventh Circuit found that the United States was barred from pursuing a claim against CMC for being an operator of the site prior to the bar date. The Seventh Circuit stated, however, that CMC could be ordered to cleanup the site as a current owner-operator of a hazardous waste site where "harmful releases are threatened or on-going...".ⁿ⁶⁷ The court analogized to lien law and found that the responsibility to cleanup a site where harmful releases are on-going or threatened runs with the land and is not dischargeable.ⁿ⁶⁸

The Second Circuit's decision in *In re Chateaugay* also addressed whether injunctive remedies are "claims" under the Bankruptcy Code. That court found that an injunction that imposes an obligation entirely as an alternative to payment is dischargeable but one that requires a debtor to take action to end or ameliorate a situation is not a claim that is dischargeable.ⁿ⁶⁹

[d] Other Contingent or Unliquidated Liabilities.

Other contingent liabilities, particularly those arising from litigation, must also be evaluated. The existence of such liabilities may be difficult to ascertain, as they may not be evident on the company's balance sheet. Allegations of

defective products, discriminatory employment practices and breach of contract or termination of leases can lead to major costs. In a chapter 11 case, such contingent liabilities will become liquidated and discharged. In an out-of-court restructuring, the lender must decide whether the continued existence of these liabilities would threaten the viability of the post-restructuring entity.

[e] Collective Bargaining Agreements.

A lender also will want to assess the company's continued obligations to unions and other representatives of its employees. A restructuring of the business may require the divestiture or discontinuance of unprofitable operations. Union contracts, post-retirement health benefits and extensive liabilities to employees can easily frustrate any attempt to sell or discontinue an affected business. If no such sale is possible, lenders should be aware that although burdensome labor contracts and retiree benefit obligations can, in some circumstances, be avoided by the trustee once a reorganization case under chapter 11 has been commenced, the Bankruptcy Code provides special protections for these classes.ⁿ⁷⁰

[4] Subordination Provisions.

A subordinated lender has additional issues to consider in assessing the pros and cons of going forward with an out-of-court restructuring. In general terms, a subordinated lender contractually agrees to defer, or "subordinate," its rights to payment of principal and interest on the funds it has advanced pending the payment of a specified portion of the principal and interest due to other "senior" lenders at any given time. Courts typically enforce subordination contracts according to their terms and in light of their purpose.ⁿ⁷¹

A primary focus of any such inquiry should be the "blockage provisions" of the relevant subordination agreement. Subordination requires that a lender "turn over" any recovery to which it might otherwise be entitled until the senior debt has been entirely repaid. As long as the borrower has not defaulted on its debt obligations, the subordinated lender may be entitled to payments of interest or principal, but the senior lender can block those payments upon the occurrence of a specified "subordination event," such as the borrower entering bankruptcy or defaulting in any payment under the terms of the senior loans. Payment blockages bar the subordinated lender from receiving payments and require it to turn over any payments in fact received to the senior lenders. They are generally accompanied by so-called "remedy bars," which prevent the subordinated lender from accelerating its loan or pursuing other remedies that may be provided by the terms of its loan agreement. In many subordinated loans, these blockages may continue only until the subordination event terminates, the senior debt is paid or a given period of time elapses. Moreover, subordination agreements usually limit the number of such blockages that may be imposed in any given year. In extreme cases, however, subordination provisions may not allow a subordinated lender to receive or retain any payments until senior lenders have been paid in full in cash. Such provisions provide the senior lender with a limited guarantee of repayment to the extent of the subordinated lender's claim.

The contract of subordination may also incorporate provisions delaying or preventing a creditor's remedies and assigning the right to file and prosecute claims in bankruptcy on behalf of the subordinated lender to the senior debt.

[5] Analysis of the Lender's Own Vulnerability.

At an early stage of a workout, the lender should also review its own prior conduct to assess possible claims against it. This requires familiarity with lender liability law--the primary subject of the remainder of this chapter. Before approaching that subject, however, the lender, as part of its initial due diligence, should analyze certain transactions made pursuant to its loan documents as well as certain structural elements of the obligations it holds to see whether they might represent potential litigation risks and loss of value to the lender in the future.

[a] Preferential Payments.

Under *section 547 of the Bankruptcy Code*,ⁿ⁷² the trustee can avoid certain transfers of property that an insolvent debtor made to a creditor in satisfaction of an antecedent debt if the debtor made the transfers within ninety days of filing its petition under the Bankruptcy Code. These transfers must enable the creditor to receive more than it would have otherwise received through a chapter 7 distribution.ⁿ⁷³ Taking a security interest on a pre-existing loan is a transfer under *section 101 of the Bankruptcy Code*. It allows a lender to improve its position from unsecured to secured and, if done within the 90 days prior to filing, may be subject to a preference attack. The creditor's lot is further complicated by the Bankruptcy Code's presumption that the debtor was insolvent during the 90-day period.ⁿ⁷⁴ Given these rules, the lender should look to see whether it or a competing creditor recently received a partial or complete payment of an outstanding debt.ⁿ⁷⁵ A conveyance of additional property as collateral or a recent filing to assure perfection of a lien or security interest previously granted may also run afoul of the statute.

[i] Insider Preferences.

In assessing its potential liability for preferential transfers, a lender must consider whether it might be deemed an "insider" of the debtor once a reorganization case has been commenced. Transfers to such "insiders" are voidable if they occurred within one year of the bankruptcy filing, not merely if they occurred within the 90-day period.ⁿ⁷⁶ Generally speaking, as defined by the Bankruptcy Code, insider status results from either a formal relationship between the debtor and creditor that indicates that the creditor has control over the debtor or from actions taken by the insider that indicate such control.ⁿ⁷⁷ A creditor may also be considered an insider of the debtor merely by being an insider of one of the debtor's affiliates.ⁿ⁷⁸ While the economic control over the debtor that a lender achieves in an arm's-length loan transaction will not ordinarily be sufficient to render the lender an insider, a lender may be deemed an insider if one of its officers sits on the debtor's board of directorsⁿ⁷⁹ or on the board of one of the debtor's affiliates or if through its equity position it has the ability to exercise control over the borrower or an affiliate.ⁿ⁸⁰

In *In re Rubin Bros. Footwear, Inc.*,ⁿ⁸¹ the court held that the lender was an insider under section 547 because of the amount of control it exerted over the borrower's affairs, specifically its ability to compel the payment of its own debts. The lender had suggested that the borrower hire a consultant to keep its business afloat but, unbeknownst to the borrower, the consultant was acting on the lender's behalf to improve the lender's position from that of an unsecured creditor to that of a secured creditor. The plaintiffs alleged, among other things, that the granting of these security interests was a voidable preference subject to the one-year period applicable to insiders. In addition, the consultant had used his position to reduce the debt of the lender, allegedly to the detriment of the unsecured creditors. Quoting *In re F & S Central Manufacturing Corp.*,ⁿ⁸² the court held that "a creditor ... who has a special relationship with the debtor through which it can compel payment of its debt, has sufficient control over the debtor to be deemed an insider."ⁿ⁸³

[ii] Insider Preferences Arising From Certain Guarantees.

Prior to the amendment of the Bankruptcy Code by the Bankruptcy Reform Act of 1994,ⁿ⁸⁴ a lender that was not an insider was at risk of finding itself subject to the one-year insider preference period if it held an insider's guarantee of the lender's debt. In *Levit v. Ingersoll Rand Financial Corp. (In re Deprizio)* ("*Deprizio*"),ⁿ⁸⁵ the Court of Appeals for the Seventh Circuit, relying on *sections 547 and 550 of the Bankruptcy Code*,ⁿ⁸⁶ reasoned that a guarantor is a creditor of a debtor because the guarantor holds a contingent subrogation claim against the debtor; if the lender collects from the guarantor, the guarantor then has a claim against the debtor. A payment to the lender benefits the guarantor because it reduces the guarantor's potential exposure. Since the guarantor is an insider, the one-year preference period applies. Thus, under *Deprizio*, a creditor that took a guarantee from an insider exposed itself to the extended preference period.ⁿ⁸⁷ This could occur in a case in which the lender obtained the guarantee of the parent of the lender's primary obligor as extra protection for its loan. Furthermore, section 550 allows the trustee to recover from either the lender or the guarantor.ⁿ⁸⁸ The *Deprizio* court noted it was not inequitable "to require the outside lenders to pursue the insider guarantors for any shortfall when they bargained for that recourse."ⁿ⁸⁹

The Bankruptcy Reform Act of 1994ⁿ⁹⁰ amended *section 550 of the Bankruptcy Code* to overrule the *Deprizio* line of

cases. Section 550(c) makes clear that noninsider transferees are not subject to the preference provisions of the Bankruptcy Code beyond the 90-day period provided for in section 547.ⁿ⁹¹

However, the Bankruptcy Reform Act of 1994 did not make a equivalent change to *Section 547 of the Bankruptcy Code*. This omission left non-insider lenders vulnerable to avoidance of transfers that indirectly benefited an insider guarantor of the debtor's debt.ⁿ⁹² The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 sought to clarify the extent to which a trustee may avoid a transfer to a non-insider beneficiary of a guarantee. *Section 547(i) of the Bankruptcy Code*, added by the 2005 Act, made clear that a preferential transfer made by the debtor to a non-insider during the one-year period before the bankruptcy petition date, for the benefit of a creditor that is an insider, is avoidable only with respect to the insider, and not with respect to the non-insider.ⁿ⁹³ⁿ⁹⁴⁻⁹⁵

[b] Upstream Guarantees.

An upstream guarantee--the term used to describe a guarantee by a subsidiary of the obligation of its parent or sister entity--is vulnerable to attack as a fraudulent conveyance under *section 548 of the Bankruptcy Code* and corresponding provisions of state law.ⁿ⁹⁶ At times, a lender's credit is advanced to a holding company. Since the holding company does not have any significant assets other than the stock of its subsidiaries, a lender might insist on an upstream guarantee from these operating subsidiaries in order to have a claim directly against the assets of the operating companies and to place that claim on a par with claims of direct creditors of those subsidiaries. Because the proceeds of the loan go to the parent rather than the subsidiary, the guarantee may be attacked under *section 548 of Bankruptcy Code* as a transfer for which the subsidiary "received less than a reasonably equivalent value in exchange."ⁿ⁹⁷ Simply put, the risk arises when a guarantor, while insolvent or otherwise in financial distress, incurs guarantee liability for the benefit of its parent without having received reasonably equivalent value for itself and its creditors in exchange.

Some lenders attempt to reduce this risk by incorporating within the upstream guarantee a contractual limitation of the subsidiary's liability to most but not all of the subsidiary's net worth. Such a limitation, or "net worth cap," is designed to ensure that the guarantee will not render the subsidiary insolvent. The lender can take some comfort from the existence of a net worth cap, but it is possible that a bankruptcy court, accustomed to determining the narrow question of whether a debtor is or is not solvent based on presumptions and burdens of proof, will not be willing to accept the daunting assignment of determining precisely how much net worth a debtor had as of the prepetition date on which the guarantee liability was incurred.ⁿ⁹⁸

FOOTNOTES:

(n1)Footnote 1. *U.C.C. § 9-502(a)*. See also *U.C.C. § 9-504* regarding sufficiency of collateral description. Article 9 of the Uniform Commercial Code has been rewritten and became effective in forty-six states, the District of Columbia and the U.S. Virgin Islands on July 1, 2001. It became effective in the remaining four states by January 1, 2002. Cites in this chapter refer to Revised Article 9. See Edwin E. Smith, *An Introduction to Revised UCC Article 9* (1999), in *The New Article 9, Uniform Commercial Code*, 2d Ed., 17-58 (Corinne Cooper, ed., A.B.A. 2000); see also Julian B. McDonnell, *Uniform Commercial Code Analysis of Revised Article 9* (Matthew Bender 1999).

(n2)Footnote 2. For a discussion of preferences, see *P 4.03[5][a] infra*.

(n3)Footnote 3. [Reserved.]

(n4)Footnote 4. As a general matter, a bankruptcy court will determine a claim as of the date of filing and will not allow recovery of postpetition interest. See *11 U.S.C. § 502(b)(2)*. Secured creditors, however, may recover interest to the extent that their total claims are oversecured but their recovery may not exceed the value of the "collateral." *11 U.S.C. § 506(b)*. Oversecured creditors may recover such interest even if they possess no contractual right to it. *United States v. Ron Pair Enters., Inc.*, 489 U.S. 235, 241-42, 109 S. Ct. 1026, 1030-31, 103 L. Ed. 2d 290, 298-99, 20 C.B.C.2d 267, 271-72 (1989). For the impact that violation of environmental laws may have on the value of collateral, see *P 4.03[3][c] infra*.

(n5)Footnote 5. In certain limited circumstances, lenders may also have other types of obligations. *See 11 U.S.C. § 362(b)*, as amended by Pub. L. No. 109-8 (2005). A commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency may set off certain mutual debts and claims under or in connection with commodity contracts or securities contracts. *See 11 U.S.C. § 362(b)(6)*. A participant in a repurchase agreement or a financial participant may set off certain mutual debts and claims under or in connection with repurchase agreements. *See 11 U.S.C. § 362(b)(7)*. A participant in a financial or swap transaction may set off certain mutual debts and claims under or in connection with a financial or swap agreement. *See 11 U.S.C. § 362(b)(17)*. The term "financial participant" was added to the Bankruptcy Code pursuant to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and is defined as:

(A) an entity that, at the time it enters into a securities contract, commodity contract, swap agreement, repurchase agreement, or forward contract, or at the time of the date of the filing of the petition, has one or more agreements or transactions described in paragraph (1), (2), (3), (4), (5), or (6) of section 561(a) with the debtor or any other entity (other than an affiliate) of a total gross dollar value of not less than \$1,000,000,000 in notional or actual principal amount outstanding on any day during the previous 15-month period, or has gross mark-to-market positions of not less than \$100,000,000 (aggregated across counterparties) in one or more such agreements or transactions with the debtor or any other entity (other than an affiliate) on any day during the previous 15-month period; or

(B) a clearing organization (as defined in section 402 of the Federal Deposit Insurance Corporation Improvement Act of 1991).

11 U.S.C. § 101(22A).

However, the setoff of otherwise non-mutual debt by contractual agreement may not give rise to a setoff claim in bankruptcy. *See In re SemGroup, L.P.*, Ch. 11 Case No. 08-1525 (Bankr. D. Del., Jan. 9, 2009) (finding a triangular setoff agreement does not give rise to a setoff claim since non-mutual debt cannot be transformed into a "mutual debt" by agreement under Section 553).

(n6)Footnote 6. *11 U.S.C. § 553*; *see also 11 U.S.C. § 506(a)* (allowed claim subject to setoff under § 553 is secured to the extent of the amount subject to setoff and is unsecured to the extent it exceeds the amount subject to setoff).

(n7)Footnote 7. For a more thorough discussion of this topic, see Collier on Bankruptcy Taxation (Matthew Bender) or 15 Collier on Bankruptcy (Matthew Bender 15th Ed. Revised).

(n8)Footnote 8. *See, e.g.*, Internal Revenue Code of 1986, as amended ("I.R.C.") §§ 11, 1442 and 3402, and Subtitle D of the I.R.C.

(n9)Footnote 9. A federal affiliated group is a chain of two or more corporations connected through stock ownership of at least 80% total voting power and value which elect to be treated as an affiliated group. *I.R.C. § 1504(a)*.

(n10)Footnote 10. *Treas. Reg. § 1.1502-6(a)*.

(n11)Footnote 11. *See generally* I.R.C. Subtitle F, Chs. 67 and 68.

(n12)Footnote 12. *I.R.C. § 6501(a)*.

(n13)Footnote 13. *I.R.C. § 6501(e)(1)(A)*.

(n14)Footnote 14. *I.R.C. § 6501(c)*.

(n15)Footnote 15. *I.R.C. § 6321.*

(n16)Footnote 16. *I.R.C. § 6322.*

(n17)Footnote 17. *I.R.C. § 6323(a).*

(n18)Footnote 18. *I.R.C. § 6323(f).*

(n19)Footnote 19. *I.R.C. § 6323(a). See United States v. City of New Britain, 347 U.S. 81, 74 S. Ct. 367, 98 L. Ed. 520 (1954) .*

(n20)Footnote 20. *I.R.C. § 6323(a), (h)(1)(A). See Glass City Bank v. United States, 326 U.S. 265, 66 S. Ct. 108, 90 L. Ed. 56 (1945) .*

(n21)Footnote 21. *See I.R.C. § 6323; 11 U.S.C. § 507(a)(1), (2) & (8).*

(n22)Footnote 22. *I.R.C. § 6323; 11 U.S.C. § 103(b).*

(n23)Footnote 23. *11 U.S.C. § 724(b).*

(n24)Footnote 24. *See I.R.C. § 7501(a).*

(n25)Footnote 25. For a more extensive discussion of the exclusion of amounts relating to trust fund taxes from the bankruptcy estate, see 15 *Collier on Bankruptcy, P TX15.02* (Matthew Bender 15th Ed. Revised).

(n26)Footnote 26. *See, e.g., Cella v. United States, 80-1 U.S. Tax. Cas. (CCH) P 9369, 1980 U.S. Dist. LEXIS 11106* (E.D.N.Y. Feb. 14, 1980) (treasurer of bankrupt corporation held liable for unpaid trust fund taxes).

(n27)Footnote 27. A "defined benefit" pension plan is one designed to provide a specific level of benefits (determined under a formula set forth in the plan document) at retirement. Such plans are funded by the sponsors on an actuarially-determined basis. *See 29 U.S.C. § 1002(35).*

(n28)Footnote 28. The lien runs in favor of the plan, but generally can be perfected and enforced only by the Pension Benefit Guaranty Corporation. *26 U.S.C. § 412(n); 29 U.S.C. § 1082(f).* For purposes of the minimum funding provisions and the application of the lien relating thereto, the controlled group includes each group of trades or businesses (whether or not incorporated) under common control, affiliated service group, and group of businesses required to be aggregated under *section 414(o) of the Internal Revenue Code*, of which the sponsor is a member. *26 U.S.C. §§ 412(n), 414(b), (c), (m) and (o); 29 U.S.C. § 1082(f).*

(n29)Footnote 29. *26 U.S.C. § 412(n).* The lien is generally equal to the amount of the aggregate unpaid installments and other unpaid minimum funding payments required under *section 412 of the Internal Revenue Code* (such as missed annual funding contributions), plus interest. *26 U.S.C. § 412(n)(3).*

(n30)Footnote 30. *26 U.S.C. 4971(a), (e)(2).* For purposes of the excise tax imposed under *section 4971 of the Internal Revenue Code*, the definition of "controlled group" is identical to the definition of controlled group for minimum funding purposes. *See n.28 supra; 26 U.S.C. 412(n), 414(b), (c), (m) and (o), 4971(e)(2), 20 U.S.C. 1082(f).*

(n31)Footnote 31. For this purpose, the "controlled group" consists only of trades or businesses (whether or not incorporated) that are under common control with the sponsor within the meaning of *sections 414(c) of the Internal Revenue Code*. *29 U.S.C. §§ 1301(b)(1), 1341(c)(2).*

(n32)Footnote 32. With respect to the reorganization under the Bankruptcy Code of a plan sponsor and each member of its controlled group, the bankruptcy court in which the bankruptcy petition is filed must determine that,

unless the underfunded plan is terminated, the plan sponsor or controlled group member will be unable to pay all of its debts pursuant to the plan of bankruptcy reorganization and continue in business outside the bankruptcy reorganization process. In addition, the bankruptcy court must approve the requested plan termination. 29 U.S.C. 1341(c)(2)(B).

(n33)Footnote 33. 29 U.S.C. § 1341(c)(2).

(n34)Footnote 34. Note that if a distress termination of a plan would violate the terms and conditions of an existing collective bargaining agreement, the PBGC will not proceed with the termination. 29 U.S.C. 1341(a)(3).

(n35)Footnote 35. Although regulations promulgated under ERISA provide the discount rate required to be used to calculate the value of a plan's unfunded benefit liabilities at the time of plan termination, courts presented with determining the present value of a pension plan's unfunded benefit liabilities in the Bankruptcy Code (which does not explicitly mandate what discount rate should be used for purposes of this type of calculation) context are split on this issue. *See* 29 C.F.R. § 4044.52. At least one circuit has held that a "prudent investor rate" (i.e., a rate of return that could be earned on investments by a reasonably prudent investor investing in order to have sufficient funds to pay benefits as they become due) should be used for these purposes because allowing the PBGC to use its own rates would be incompatible with the Bankruptcy Code mandate that same-class creditors be treated equally. *See Pension Benefit Guar. Corp. v. Belfance (In re CSC Indus., Inc.)*, 232 F.3d 505, 45 C.B.C.2d 181 (6th Cir. 2000) . *See also Pension Benefit Guar. Corp. v. CF & I Fabricators (In re CF & I Fabricators)*, 150 F.3d 1293 (10th Cir. 1998) . However, in more recent cases under the Bankruptcy Code, courts have that PBGC claims for unfunded benefit liabilities must be determined using the PBGC valuation regulation promulgated under *section 4044 of ERISA* and that the application of a "prudent investor rate" was inappropriate. *In re US Airways Group, Inc.*, 303 B.R. 784 (Bankr. E.D. Va.) (*relying on Raleigh v. Illinois Dep't of Revenue*, 530 U.S. 15 (2000) , which concluded that a creditor's claim is primarily based on the underlying substantive law creating the claim and that the Bankruptcy Code does not supercede such underlying law); *See also Dugan v. Pension Benefit Guar. Corp. (In re Rhodes, Inc.)*, 382 B.R. 550 (N.D. Ga. 2008) (rejecting the "prudent investor rate" and affirming use of the PBGC regulation).

(n36)Footnote 36. 29 U.S.C. §§ 1341, 1362, 1368. Only controlled group members with positive net worth are taken into account in determining the maximum lien amount. 29 U.S.C. § 1362(d). The plan sponsor and members of its controlled group are jointly and severally liable for the amount of this lien. 29 U.S.C. § 1362(a).

(n37)Footnote 37. 29 U.S.C. § 1342(a). The PBGC can initiate a plan termination if, *inter alia*, the minimum funding requirements are not met, the plan will be unable to pay benefits when due, or the PBGC determines that its "possible long-run loss ... with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated." 29 U.S.C. § 1342.

(n38)Footnote 38. *See* 26 U.S.C. § 412(n)(4), § 6323, 29 U.S.C. § 1368(c). *Section 724(d) of the Bankruptcy Code* provides that the order of distribution with respect to property subject to ERISA liens shall be the same as that for tax liens. *See* 11 U.S.C. § 724(d); 4 *Collier on Bankruptcy*, P 724.05 (Matthew Bender 15th Ed. Revised); S. Rep. No. 95-989, at 96, 95th Cong., 2d Sess. (1978), *reprinted in* Vol. D *Collier on Bankruptcy*, Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n39)Footnote 39. *See, e.g., Pension Benefit Guar. Corp. v. Belfance (In re CSC Indus., Inc., 232 F.3d 505, 45 C.B.C.2d 181 (6th Cir. 2000) ; Pension Benefit Guar. Corp. v. CF & I Fabricators (In re CF & I Fabricators), 150 F.3d 1293 (10th Cir. 1998) ; Pension Benefit Guar. Corp. v. Skeen (In re Bayly Corp.), 163 F.3d 1205 (10th Cir. 1998) ; In re Kent Plastics Corp., 183 B.R. 841 (Bankr. S.D. Ind. 1995) .*

(n40)Footnote 40. Some courts will afford priority status to claims arising from postpetition services as they are likely to be considered administrative expenses of the bankruptcy estate. *See* 11 U.S.C. §§ 503(b)(1)(B), 507(a)(2). *See, e.g., In re CF & I Fabricators*, 150 F.3d 1293 (10th Cir. 1998) ; *In re Bayly Corp.*, 163 F.3d 1205 .

Furthermore, certain claims for contributions to a plan in the 180 days preceding the filing of the petition for bankruptcy protection up to a maximum amount of \$10,950 per individual or corporation are afforded fourth priority status under the Bankruptcy Code. 11 U.S.C. § 507(a)(4), as amended by Pub. L. No. 109-8 (2005). *See e.g., In re Sunarhauserman, Inc.*, 184 B.R. 273 (Bankr. N.D. Ohio 1995) .

(n41)Footnote 41. A multiemployer plan is a defined benefit plan to which more than one unrelated company contributes pursuant to a collective bargaining agreement. *See* 29 U.S.C. §§ 1002(37), 1301(a)(3). The Internal Revenue Code and ERISA set forth funding requirements for multiemployer plans which differ from those established for single employer plans. *See* 26 U.S.C. §§ 431, 432; 29 U.S.C. §§ 1084, 1085.

(n42)Footnote 42. 29 U.S.C. §§ 1381 *et seq.*

(n43)Footnote 43. Because of its potential impact, for purposes of this discussion of a borrower's potential environmental liability, CERCLA is the focus. However, lenders must be cognizant of the obligations imposed by other environmental laws. For example, a company may be obligated to spend millions of dollars to bring its facilities into compliance with the federal Clean Air Act. Lenders must also recognize that states can impose requirements that can be stricter than those imposed under federal environmental laws.

(n44)Footnote 44. 42 U.S.C. §§ 9601-9675.

(n45)Footnote 45. *In re Strong*, No. BK00-81356, 2002 Bankr. LEXIS 1783 (Bankr. D. Neb. Sept. 27, 2002) (government's enforcement action to compel compliance with environmental regulations not stayed by bankruptcy case); *Penn Terra, Ltd. v. Dep't. of Env'tl. Res.*, 733 F.2d 267, 275-79, 10 C.B.C.2d 949, 959-63 (3d Cir. 1984) (government's injunction against debtor requiring compliance with cleanup procedures not stayed since money judgment not imposed); *In re Strong*, No. BK00-81356, 2002 Bankr. LEXIS 1783 (Bankr. D. Neb. Sept. 27, 2002) (government's enforcement action to compel compliance with environmental regulations not stayed by bankruptcy case); *In re Basinger*, No. 01-02386, 2002 Bankr. LEXIS 1925 (Bankr. D. Idaho Jan. 31, 2002) (government's enforcement action to compel compliance with environmental regulations not stayed by bankruptcy case). *See also In re Unidigital, Inc.*, 262 B.R. 283, 285-87 (Bankr. D. Del. 2001) for a discussion of the related issue concerning limitations on the debtor's ability to abandon estate property.

(n46)Footnote 46. *See, e.g.,* 11 U.S.C. §§ 503(b)(1)(A) and 507(a)(2); *Cumberland Farms, Inc. v. Fla. Dep't of Env'tl. Prot.*, 116 F.3d 16 (1st Cir. 1997) (correction of environmental violations is administrative expense having priority over unsecured claims in bankruptcy); *In re Wall Tube & Metal Prods. Co.*, 831 F.2d 118, 123-24, 17 C.B.C.2d 736, 742-43 (6th Cir. 1987) (government expenses to alleviate environmental hazard constituted priority administrative expense); *United States v. Chateaugay Corp. (In re Chateaugay Corp.)*, 112 B.R. 513, 525-26 (S.D.N.Y. 1990) (government's cleanup costs incurred postpetition but preconfirmation were administrative priority expenses), *aff'd*, 944 F.2d 997, 25 C.B.C.2d 620 (2d Cir. 1991) . *See also* *Midlantic Nat'l Bank v. N.J. Dep't of Env'tl. Prot.*, 474 U.S. 494, 13 C.B.C. 2d 1355 (1986) (bankruptcy trustee cannot abandon contaminated property in contravention of state law designed to protect health and safety); *Pa. Dep't of Env'tl. Res. v. Conroy*, 24 F.3d 568, 569-70 (3d Cir. 1994) (holding that when a site cannot be abandoned due to hazardous environmental conditions, the cost of cleanup is deemed an administrative expense); *New York v. HSBC Bank USA, N.A.*, No. 07 Civ. 3160 (S.D.N.Y. May 30, 2007) (lender cannot ignore toxic cleanup laws by seizing a company's operating funds and leaving it without the financial ability to be in compliance with environmental laws). For a discussion of the differing approaches taken by the courts with respect to the issue of administrative expenses for environmental cleanups, *see Coal Stripping, Inc. v. Clarendon Nat'l Ins. Co. (In re Coal Stripping, Inc.)*, 222 B.R. 78 (Bankr. W.D. Pa. 1998) .

(n47)Footnote 47. *Cal. Dep't. of Health Servs. v. Jensen (In re Jensen)*, 995 F.2d 925 (9th Cir. 1993) , C.B.C.2d 101 (9th Cir. 1993). *See also In re Chi., Milwaukee, St. Paul & Pac. R.R. Co.*, 3 F.3d 200, 201, 29 C.B.C.2d 705 (7th Cir. 1993) (noting the "profound" tension between CERCLA and the bankruptcy laws).

(n48)Footnote 48. See 42 U.S.C. § 9601(20)(F). For a more detailed discussion of lender liability under CERCLA, see discussion *infra* at P 4.05A[3] concerning the Asset Conservation, Lender Liability, and Deposit Insurance Protection Act of 1996.

(n49)Footnote 49. 944 F.2d 997, 1010, 25 C.B.C.2d 620, 636 (2d Cir. 1991) . See also *In re Wall Tube & Metal Prods. Co.*, 831 F.2d 118, 123-24, 17 C.B.C.2d 736, 743 (6th Cir. 1987) ; *In re Circle K Corp.*, 137 B.R. 346 (Bankr. D. Ariz. 1992) .

(n50)Footnote 50. See, e.g., Conn. Gen. Stat. § 22a-452a (2004); Me. Rev. Stat. Ann. tit. 38, § 1371 (2003); Mass. Ann. Laws ch. 21E § 13 (LexisNexis 2002); N.J. Stat. Ann. § 58:10-23.11f (West 2004).

(n51)Footnote 51. 11 U.S.C. § 101(12) (definition of "debt").

(n52)Footnote 52. See *supra* P 1.07 for a discussion of this issue.

(n53)Footnote 53. See, e.g., *In re Chateaugay Corp.*, 944 F.2d 997, 1002, 25 C.B.C.2d 620, 625 (2d Cir. 1991) ("[t]he Bankruptcy Code and CERCLA point toward competing objectives."); *In re Nat'l Gypsum Co.*, 139 B.R. 397, 404, 27 C.B.C.2d 199, 207 (N.D. Tex. 1992) ("[i]t is not a question of which statute should be accorded primacy over the other, but rather what interaction between the two statutes serves most faithfully the policy objectives embodied in the two separate enactments of Congress"); *In re US Airways Group, Inc.*, 296 B.R. 673 (E.D. Va. 2003) .

(n54)Footnote 54. 944 F.2d 997, 1002, 25 C.B.C.2d 620, 626 .

(n55)Footnote 55. 944 F.2d 997, 1003, 25 C.B.C.2d 620, 627 (citing Thomas H. Jackson, *The Logic and Limits of Bankruptcy Law*, 34-35 (1986)).

(n56)Footnote 56. 944 F.2d 997, 1002, 1004, 25 C.B.C.2d 620, 629 .

(n57)Footnote 57. *Id.*

(n58)Footnote 58. *In re Nat'l Gypsum Co.*, 139 B.R. 397, 407, 27 C.B.C.2d 199, 210 (N.D. Tex. 1992) .

(n59)Footnote 59. See *United States v. Union Scrap Iron & Metal*, 123 B.R. 831, 838 (D. Minn. 1990) ; but see *Sylvester Bros. Dev. Co. v. Burlington N. R.R. Metal-Matic, Inc.*, 133 B.R. 648, 653 (D. Minn. 1991) .

(n60)Footnote 60. *In re Chi, Milwaukee, St. Paul & Pac. R.R. Co.*, 974 F.2d 775, 786 (7th Cir. 1992) , *aff'd in part, vacated in part*, 3 F.3d 200, 29 C.B.C.2d 705 (7th Cir. 1993) .

(n61)Footnote 61. *In re Chi, Milwaukee, St. Paul & Pac. R.R. Co.*, 974 F.2d 775, 786 (7th Cir. 1992) , *aff'd in part, vacated in part*, 3 F.3d 200, 29 C.B.C.2d 705 (7th Cir. 1993) (decided under Section 77 of the former Bankruptcy Act).

(n62)Footnote 62. 27 C.B.C.2d 199, 139 B.R. 397 (N.D. Tex. 1992) .

(n63)Footnote 63. 139 B.R. at 407-08, 27 C.B.C.2d at 211 . See also *AM Int'l, Inc. v. Datacard Corp.*, 146 B.R. 391 (N.D. Ill. 1992) , *aff'd in part, vacated in part*, 106 F.3d 1342 (7th Cir. 1997) .

(n64)Footnote 64. 27 C.B.C.2d at 212, 139 B.R. at 408 .

(n65)Footnote 65. See, e.g., *La. Dep't of Env'tl. Quality v. Crystal Oil Co. (In re Crystal Oil Co.)*, 158 F.3d 291 (5th Cir. 1998) ; *AM Int'l, Inc. v. Datacard Corp.*, 146 B.R. 391 (N.D. Ill. 1992) , *aff'd in part, vacated in part*, 106 F.3d 1342 (7th Cir. 1997) .

(n66)Footnote 66. 966 F.2d 1143 (7th Cir. 1992) .

(n67)Footnote 67. *Id.* at 1147 .

(n68)Footnote 68. *Id.*

(n69)Footnote 69. *In re Chateaugay Corp.*, 944 F.2d 997, 1008, 25 C.B.C.2d 620, 633 (2d Cir. 1991) .

(n70)Footnote 70. Labor contracts: *see* 11 U.S.C. § 1113; retiree benefit obligations: *see* 11 U.S.C. § 1114. Lenders should be aware of the general requirement of these sections that bargaining take place in good faith.

(n71)Footnote 71. *See In re Envirodyne Indus., Inc.*, 29 F.3d 301, 305-06 (7th Cir. 1994) (enforcing subordination under indenture's "X Clause" in light of clause's language and purpose of such clauses generally).

(n72)Footnote 72. 11 U.S.C. § 547(b), as amended by Pub. L. No. 109-8 (2005). 11 U.S.C. § 547(b) states:

(b) Except as provided in subsections (c) and (i) of this section, the trustee may avoid any transfer of an interest of the debtor in property--

(1) to or for the benefit of a creditor;

(2) for or on account of an antecedent debt owed by the debtor before such transfer was made;

(3) made while the debtor was insolvent;

(4) made--

(A) on or within 90 days before the date of the filing of the petition; or

(B) between ninety days and one year before the date of the filing of the petition, if such creditor at the time of such transfer was an insider; and

(5) that enables such creditor to receive more than such creditor would receive if--

(A) the case were a case under chapter 7 of this title;

(B) the transfer had not been made; and

(C) such creditor received payment of such debt to the extent provided by the provisions of this title.

(n73)Footnote 73. *See P 1.08[3][b] supra* for a discussion of section 547.

(n74)Footnote 74. *See* 11 U.S.C. § 547(f).

(n75)Footnote 75. The Supreme Court has held that payments on both long-term and short-term debt may qualify as payments made in the ordinary course of business and, therefore, may be immune to attack as voidable preferences. *See Union Bank v. Wolas*, 502 U.S. 151, 112 S. Ct. 527, 533, 116 L. Ed. 2d 514, 25 C.B.C.2d 1011 (1991) .

Further, following Judge Posner's opinion in *In re Tolona Pizza Products Corp.*, 3 F.3d 1029 (7th Cir. 1993) , the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended section 547 to clarify the meaning of "ordinary course." In *In re Tolona Pizza Products Corp.*, Judge Posner found that the dealings between the debtor and the allegedly favored creditor need not conform to some industry standard, but to the practice established by the particular debtor and the creditor in the period, (if possible, well) before the preference period. *Id.* at 1032 . The 2005

Act has codified that decision, protecting payments that, while not made in accordance with ordinary business terms, were nevertheless ordinary as between the parties. *See 11 U.S.C. § 547(c)(2)(A) & (B)*, as amended by Pub. L. No. 109-8 (2005).

(n76)Footnote 76. *11 U.S.C. § 547(b)(4)(B)*.

(n77)Footnote 77. The definition of "insider" may be found at *11 U.S.C. § 101*. Generally, when the debtor is a corporation, it includes officers, directors and persons in control of the corporation, as well as relatives of these persons.

(n78)Footnote 78. *See 11 U.S.C. § 101*.

(n79)Footnote 79. *See id.*

(n80)Footnote 80. An affiliate is an insider pursuant to *11 U.S.C. § 101*. Ownership of twenty percent or more of a borrower's stock will make the lender an affiliate, also pursuant to *11 U.S.C. § 101*, and therefore an insider.

(n81)Footnote 81. *73 B.R. 346, 354 (S.D.N.Y. 1987)*.

(n82)Footnote 82. *13 C.B.C.2d 805, 811, 53 B.R. 842, 848 (Bankr. E.D.N.Y. 1985)*.

(n83)Footnote 83. *In re Rubin Bros. Footwear*, *73 B.R. 346, 354*; but *cf. In re Jefferson Mortgage Co.*, *25 B.R. 963, 970 (Bankr. D.N.J. 1982)* (finding that the repayment of the borrower's debt did not render the lender an insider, stating that the debtor-creditor relationship is normally an arm's-length transaction:

The [b]ank may have exercised some measure of control over the debtor financially in order to protect its collateral. However, this control was merely incident to their creditor-debtor relationship. The creditor had only financial power over the debtor, and the debtor could have terminated the relationship at any time and looked for another creditor.).

Id. at 970.

(n84)Footnote 84. Pub. L. No. 103-394 (enacted on October 22, 1994), and *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n85)Footnote 85. *874 F.2d 1186, 22 C.B.C.2d 36 (7th Cir. 1989)*.

(n86)Footnote 86. *11 U.S.C. § 550(a)* states:

(a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section ... 547 ... of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from--

(1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or

(2) any immediate or mediate transferee of such initial transferee.

(n87)Footnote 87. *See also Official Unsecured Creditors Comm. v. U.S. Nat'l Bank (In re Suffola, Inc.)*, *2 F.3d 977, 29 C.B.C.2d 984 (9th Cir. 1993)*; *Ray v. City Bank & Trust Co. (In re C-L Cartage Co.)*, *16 C.B.C.2d 766, 70 B.R. 928 (Bankr. E.D. Tenn. 1987)*, *aff'd*, *22 C.B.C.2d 901, 113 B.R. 416 (E.D. Tenn. 1988)*, *aff'd in part, rev'd in part*, *899 F.2d 1490, 22 C.B.C.2d 901 (6th Cir. 1990)*; *Lowrey v. First Nat'l Bank of Bethany (In re Robinson Bros. Drilling, Inc.)*, *21 C.B.C.2d 1405, 97 B.R. 77 (W.D. Okla. 1988)*, *aff'd sub nom. In re Manufacturers Hanover Leasing Corp.*,

892 F.2d 850, 21 C.B.C.2d 1405 (10th Cir. 1989) , appeal after remand, *Lowrey v. Manufacturers Hanover Leasing Corp. (In re Robinson Bros. Drilling)*, 6 F.3d 701, 29 C.B.C.2d 1399 (10th Cir. 1993) ; *In re T.B. Westex Foods, Inc.*, 950 F.2d 1187, 26 C.B.C.2d 682 (5th Cir. 1992) .

Deprizio, however, was strongly criticized. See *Official Creditors' Committee of Arundel Hous. Components, Inc. v. Georgia-Pacific Corp. (In re Arundel Hous. Components, Inc.)*, 126 B.R. 216, 219 (Bankr. D. Md. 1991) and cases cited therein ("This Court strongly disapproves of the *Deprizio* decision because it represents an incorrect interpretation of the law whose application would subvert justice, produce much needless mischief and create an unfortunate result in the instant case. The Court of Appeals for the Fourth Circuit has not adopted the *Deprizio* view and it should not do so."). See also *Performance Communications, Inc. v. First Nat'l Bank (In re Performance Communications, Inc.)*, 24 C.B.C.2d 1655, 1660, 126 B.R. 473, 477 (Bankr. W.D. Pa. 1991) (stating "it would be grossly inequitable to penalize Bank for its prudence in seeking a guarantor in this case"); *In re Rubin Bros. Footwear, Inc.*, 119 B.R. 416, 425 (S.D.N.Y. 1990) ("Because of its potential policy implications, and because the Second Circuit has not adopted it, the Court declines to apply the [*Deprizio*] rule to the instant case.").

(n88)Footnote 88. See *P 1.08[3][e] supra* for a discussion of section 550.

(n89)Footnote 89. 874 F.2d 1186, 1198, 22 C.B.C.2d 36, 51-52 .

(n90)Footnote 90. Pub. L. No. 103-394 (enacted on October 22, 1994).

(n91)Footnote 91. Section 550(c) provides:

(c) If a transfer made between 90 days and one year before the filing of the petition--

(1) is avoided under section 547(b) of this title; and

(2) was made for the benefit of a creditor that at the time of such transfer was an insider;

the trustee may not recover under subsection (a) from a transferee that is not an insider.

11 U.S.C. § 550(c). But see *Blevins Elec. v. First Am. Nat'l Bank (In re Blevins Elec., Inc.)*, 34 C.B.C.2d 377, 185 B.R. 250 (Bankr. E.D. Tenn. 1995) (1994 amendment to section 550(c) does not apply to cases commenced prior to October 22, 1994; accordingly, amendment does not apply to any adversary proceedings arising out of such cases). But cf. *Pereira v. Lehigh Sav. Bank, SLA (In re Artha Mgmt.)*, 174 B.R. 671, 677 (Bankr. S.D.N.Y. 1994) (viewing the 1994 amendment as a mere clarification of section 550 and refusing to apply *Deprizio* to actions commenced before October 22, 1994).

(n92)Footnote 92. See Report of the Committee on the Judiciary, H.R. Rep. No. 109-31, pt. 1, to accompany S. 256, 109th Cong., 1st Sess., at 144 (2005) (acknowledging that the Bankruptcy Reform Act of 1994, while addressing *Deprizio* through the addition of Section 550(c), failed to make the necessary corresponding amendment to Section 547).

(n93)Footnote 93. See 11 U.S.C. § 547(i), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005).

(n94)Footnote 94-95. [Reserved.]

(n95)Footnote 96. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 changed the avoidance period for fraudulent transfers and obligations from one year to two years. 11 U.S.C. § 548(a), as amended by Pub. L. No. 109-8 (2005) (enacted on April 20, 2005, and effective in cases filed more than one year after that date). See *P 4.06*

infra for a detailed discussion of the law of fraudulent conveyances; *see also* P 1.08[3][c] *supra*.

(n96)Footnote 97. 11 U.S.C. § 548. In 1998, the "Religious Liberty and Charitable Donation Protection Act of 1998" (Pub. L. No. 105-183) was passed, effective in all cases pending or commenced as the date of enactment, June 19, 1998. Sections 548, 707 and 1325 of the *Bankruptcy Code* were amended. These amendments affect the ability of a bankruptcy trustee to avoid fraudulent transfers and obligations because a transfer of a charitable contribution to a qualified religious or charitable institution will not always be considered a fraudulent transfer. The amendments further prohibit the trustee from avoiding these charitable contributions when acting as lien creditor and successor to certain creditors and purchasers.

See, e.g., Rubin v. Mfrs. Hanover Trust Co., 661 F.2d 979, 991 (2d Cir. 1981) ; *Barr & Creelman Mill & Plumbing Supply Co. v. Zoller*, 109 F.2d 924, 925, 927 (2d Cir. 1940) . *See generally*, Kenneth J. Carl, *Fraudulent Transfer Attacks on Guaranties in Bankruptcy*, 60 *Am. Bankr. L.J.* 109 (1986). Such transfers may also run afoul of section 4 of the Uniform Fraudulent Transfer Act (UFTA), which parallels section 548, or the requirement in section 4 of the Uniform Fraudulent Conveyance Act (UFCA) that the debtor receive "fair consideration" for all transfers.

(n97)Footnote 98. In certain circumstances the "net worth cap" might exacerbate the lender's exposure. For example, in the case of guarantee transactions governed by the UFTA and its four-year statute of limitations, the "net worth cap" will have the undeniable effect of preserving a fraudulent conveyance limitation on the upstream guaranty for an unlimited period of time, even when the issue of enforcement arises more than four years after the obligation was originally incurred. *See* Brad R. Godshall & Robert A. Klyman, *Wading "Upstream" in Leveraged Transactions: Traditional Guarantees v. "Net Worth" Guarantees*, 46 *Bus. Law.* 391 (1991).



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CHAPTER 4 Representing the Lender

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P 4.04 The Lender's Obligation of Good Faith and Fair Dealing.

[1] Generally.

Whenever a lender has a contractual relationship with a borrower, the lender must consider its implied obligation of good faith and fair dealing. The same obligation acts as a constraint during a workout when the lender acts within the scope of an existing contract.

Under common law, "every contract contains the implied requirement of good faith and fair dealing."ⁿ¹ In addition to that common law obligation of good faith and fair dealing, secured lenders operating under the UCC are subject to the similar provision of *section 1-203 of the UCC*.ⁿ² Section 1-203 applies to all articles of the UCC including article 9, which deals with secured transactions.

Under the UCC, a party may not waive the obligation of good faith.ⁿ³ However, a lender has the right to accelerate a debt "at will" or "when he deems himself insecure" if the lender has a good faith belief that payment is impaired.ⁿ⁴

[2] The Lender's Discretion in Termination of a Line of Credit.

One of the most dangerous quandaries for a lender arises when the lender seeks to reduce its exposure to an existing borrower. What flexibility does the lender have and when can its conduct give rise to liability?

The Sixth Circuit's decision in *K.M.C. Co. v. Irving Trust Co.* ⁿ⁵ is the leading case imposing liability on a lender for terminating a line of credit in bad faith and addressing the interplay between the lender's obligation to deal with the borrower in good faith and a lender's contractual right to terminate a line of credit. One commentator has praised the court in *K.M.C.* for informing lenders of their underlying obligation of good faith and fair dealing.ⁿ⁶ Another commentator has criticized the *K.M.C.* decision because "in its eagerness to impose a duty of good faith on lenders, it failed to consider what that duty means."ⁿ⁷ Because the obligation of good faith and fair dealing is difficult to define in the abstract, the lender and its counsel must look closely at particular applications of the obligation.

In *K.M.C.*, Irving Trust Co. provided K.M.C. with an initial \$3 million line of credit pursuant to a financing agreement. The agreement provided that the lender's advances were discretionary. The loan agreements also provided that the advance rate was to be determined by a percentage of account receivables and inventory. In exchange for the loan, the borrower granted the lender a security interest in its accounts receivable and inventory. Three years after the original

loan agreement was signed, the lender without prior notice refused to advance the borrower \$800,000, an amount within the credit limit the parties had agreed upon. As a result, K.M.C. went out of business. K.M.C. sued Irving, and a jury found Irving liable for \$7.5 million for breach of contract.

On appeal, the lender argued that its decision not to advance additional funds was within the reasonable exercise of its discretion under the financing agreement. The court rejected Irving's argument and imposed a notice requirement upon a lender, requiring the lender to allow the borrower a reasonable amount of time to seek alternate financing before terminating the borrower's line of credit, absent a valid business reason for failing to provide notice.ⁿ⁸ *K.M.C.* has been read to mean that a lender cannot suddenly withdraw previously agreed upon financing if the lender has enough collateral to support the financing.ⁿ⁹

One commentator views the *K.M.C.* decision as the enforcement of an express provision of the loan documents.ⁿ¹⁰ Another commentator criticizes the *K.M.C.* decision because "the notice requirement transforms an agreement from one where the lender had sole discretion over whether to continue funding into one where this discretion is vested in the borrower."ⁿ¹¹

The Sixth Circuit's decision in *K.M.C.* has been under siege by both commentators and the courts since 1985.ⁿ¹² In *Kham & Nate's Shoes No. 2, Inc. v First Bank of Whiting ("First Bank of Whiting")*,ⁿ¹³ the Court of Appeals for the Seventh Circuit refused to impose liability on the lender for exercising its contractual right to cease making further advances after loaning \$75,000 to the debtor. The contract in *First Bank of Whiting*, unlike the contract in *K.M.C.*, expressly provided for cancellation of the line of credit on five days' notice and stated that "nothing provided herein shall constitute a waiver of the right of the Bank to terminate financing at any time."ⁿ¹⁴ The court stated that the concept of good faith may not be invoked to "block use of terms that actually appear in the contract."ⁿ¹⁵ The court in *First Bank of Whiting* refused to find any lack of good faith when a party protected itself in a way contemplated by the parties at the time the agreement was drafted.

The Court of Appeals for the Fifth Circuit's decision in *In re Clark Pipe & Supply Co.* ⁿ¹⁶ is in accord with *First Bank of Whiting*. In *Clark Pipe*, a loan agreement between the lender and debtor established a line of credit and provided that the lender could reduce the amount advanced to the debtor at any time in its discretion.ⁿ¹⁷ The court found that the loan and security agreements between debtor and lender were "entered into at arm's length prior to [the debtor's] insolvency and all of [the lender's] activities were conducted pursuant to those agreements."ⁿ¹⁸ The court, relying upon the rationale of *In re W.T. Grant Co.*,ⁿ¹⁹ found that the lender was not a fiduciary of the debtor, did not exert improper control over the debtor's financial affairs and did not act inequitably in exercising its right under its loan agreement with the debtor.ⁿ²⁰

[3] Demand Notes.

In *K.M.C.*, the financing agreement provided that the loan was repayable upon demand. The *K.M.C.* decision has been criticizedⁿ²¹ because it did not deal with the official comment to section 1-208 of the UCC, which states that the good faith requirement of section 1-208 does not apply to demand instruments.ⁿ²² However, the demand note language in *K.M.C.* was inconsistent with financial covenants and events of default provisions in the loan agreement. In effect, the court in *K.M.C.* disregarded the demand provision and held that the demand note was "a kind of acceleration clause" that is subject to the good faith standard under the UCC.ⁿ²³ As this case and others make clear, an instrument that purports to be a demand note may not be deemed such when the loan documents contain provisions inconsistent with a demand note.ⁿ²⁴

The lender should thus bear in mind that courts may enforce the express terms of a demand note if the parties clearly intended through their loan documents to create a demand relationship.ⁿ²⁵ However, when the loan documents include events of default that are by their nature inconsistent with the demand relationship, courts are likely to imply the obligation of good faith when the lender demands payment.

[4] Remedies for Breach of the Implied Contractual Obligation of Good Faith.

In general, the remedy for breach of the implied contractual obligation of good faith is compensatory damages.ⁿ²⁶ However, a few courts have disregarded this general rule and awarded punitive damages for a contractual breach of the implied covenant of good faith and fair dealing.ⁿ²⁷

[5] Risk Minimization Strategies.

When a borrower encounters financial difficulties, the lender should take precautions against claims of bad faith.ⁿ²⁸ For example, some authority suggests that the lender should document significant contacts with the debtor, and the documentation should be consistent with the lender's actions.ⁿ²⁹ There are, however, often severe practical constraints on such an approach due, for example, to the speed of unfolding events and a desire to keep working relations on a less formal basis. Nonetheless, unusual circumstances may make it appropriate for the workout account officer to send to the borrower some written confirmation of key understandings. In any event, the loan agreement should explicitly state that it reflects the entire understanding of the parties.

If the lender decides to restructure the loan, the lender may adjust the debtor's borrowing base formulaⁿ³⁰ and/or shorten the length of time that an account debt has been outstanding.ⁿ³¹ Both of these options would effectively decrease the amount of funds the debtor may borrow. In addition, in exchange for a more lenient payment schedule the lender may demand guarantees by the borrower and the borrower's business entities, a waiver of defenses on the underlying debt and a pledge of additional collateral.ⁿ³² Even though a transfer of new collateral may later be voidable as a preference in a bankruptcy proceeding, it may still provide a measure of additional security.

If the lender decides to increase the monitoring of the debtor's business and its collateral, the lender should renegotiate the loan agreement to state expressly that the debtor is obligated to provide more frequent financial reporting. This will enable the lender to react more efficiently to any risks associated with its collateral. When the lender's collateral consists of inventory, periodic on-site inspections would ensure that the debtor is reporting its inventory accurately.

Demand instruments must be consistent with the other provisions of the loan agreement so it is clear that the parties intended to create a demand loan relationship.ⁿ³³

To terminate the debtor's financing, the lender must do so without breaching its obligation of good faith and fair dealing.ⁿ³⁴ The general guidelines for an effective termination are: "actual impairment of the collateral or prospect of repayment, reasonable notice, and certainty of termination."ⁿ³⁵ *K.M.C.* suggests that while a showing of actual impairment of collateral is not a requirement of the obligation of good faith and fair dealing, "it may help avoid a possible inference of bad faith."ⁿ³⁶ The lender should not foreclose on collateral without giving reasonable notice to the borrower,ⁿ³⁷ unless the lender believes the collateral is in danger of being impaired.ⁿ³⁸ It is also helpful if the lender delivers the notice of termination to the debtor in unequivocal, written correspondence.ⁿ³⁹

FOOTNOTES:

(n1)Footnote 1. *Van Gemert v. Boeing Co.*, 553 F.2d 812, 815 (2d Cir. 1977) ; see also *Kirke La Shelle Co. v. Paul Armstrong Co.*, 188 N.E. 163, 167 (N.Y. 1933) ("in every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract, which means that in every contract there exists an implied covenant of good faith and fair dealing"), cited in *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760 (6th Cir. 1985) .

(n2)Footnote 2. *U.C.C.* § 1-203 states: "Every contract or duty within this Act imposes an obligation of good faith in its performance or enforcement."

(n3)Footnote 3. *U.C.C.* § 1-102(3) provides:

The effect of provisions of this Act may be varied by agreement, except as otherwise provided in this Act and except that the obligations of good faith, diligence, reasonableness and care prescribed by this Act may not be disclaimed by agreement but the parties may by agreement determine the standards by which the performance of such obligations is to be measured if such standards are not manifestly unreasonable.

(n4)Footnote 4. U.C.C. § 1-208, states:

A term providing that one party or his successor in interest may accelerate payment or performance or require collateral or additional collateral "at will" or "when he deems himself insecure" or in words of similar import shall be construed to mean that he shall have power to do so only if he in good faith believes that the prospect of payment or performance is impaired. The burden of establishing lack of good faith is on the party against whom the power has been exercised.

The official comment to section 1-208 states: "Obviously this section has no application to demand instruments or obligations whose very nature permits call at any time with or without reason."

(n5)Footnote 5. 757 F.2d 752 (6th Cir. 1985) .

(n6)Footnote 6. See, e.g., H. Chaitman, *The Law of Lender Liability* PP 4.01, 4.03[1][a] (WGL 1990) ["Chaitman"].

(n7)Footnote 7. Fischel, *The Economics of Lender Liability*, 99 Yale L.J. 131, 144 (1989) ["Fischel"].

(n8)Footnote 8. K.M.C. Co., 757 F.2d at 759 .

(n9)Footnote 9. Chaitman, n.6 *supra* , at P 4.03[1][a]. But see *Spencer Cos. v. Chase Manhattan Bank, N.A.*, 81 B.R. 194, 199 (D. Mass. 1987) (refusing to accept K.M.C. as a correct statement of New York law).

(n10)Footnote 10. See, e.g., Chaitman, n.6 *supra* , at P 4.03[1][b].

(n11)Footnote 11. Fischel, n.7 *supra* , at 144.

(n12)Footnote 12. See Steven G. Hilfinger, Note, *K.M.C. Co. v. Irving Trust Co.: Discretionary Financing and the Implied Duty of Good Faith*, 81 Nw. U.L. Rev. 539 (1987) ["Discretionary Financing"]; see also *Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1358, 23 C.B.C.2d 1118, 1125-26 (7th Cir. 1990) (disagreeing with K.M.C.'s holding "that a bank must loan more money or give more advance notice of termination than its contract requires"), *rehearing denied en banc*, 1990 U.S. App. LEXIS 18381 (7th Cir. Oct. 12, 1990) ; Fischel, n.7 *supra* , at 143-44 (finding the K.M.C. decision to be wrongly decided because the notice requirement created in K.M.C. cannot be justified by a duty of good faith that deters opportunistic behavior).

(n13)Footnote 13. 908 F.2d 1351, 23 C.B.C.2d 1118 (7th Cir. 1990) .

(n14)Footnote 14. 908 F.2d 1351, 1353, 23 C.B.C.2d 1118, 1120 (7th Cir. 1990) .

(n15)Footnote 15. 908 F.2d 1351, 1357, 23 C.B.C.2d 1118, 1125 (7th Cir. 1990) .

(n16)Footnote 16. 893 F.2d 693, 22 C.B.C.2d 500 (5th Cir. 1990) .

(n17)Footnote 17. 893 F.2d 693, 700, 22 C.B.C.2d 500, 508 (5th Cir. 1990) .

(n18)Footnote 18. 893 F.2d 693, 702, 22 C.B.C.2d 500, 510 (5th Cir. 1990) .

(n19)Footnote 19. 699 F.2d 599 (2d Cir.) , cert. denied, 464 U.S. 822, 104 S. Ct. 89, 78 L. Ed. 2d 97 (1983) ; see P 4.07 [3] n.7 *infra* for a discussion of this case.

(n20)Footnote 20. 893 F.2d 693, 702, 22 C.B.C.2d 500, 511 (5th Cir. 1990) .

(n21)Footnote 21. See *Discretionary Financing*, n.12 *supra*, at 562 ("By their very nature, demand instruments are immediately due and payable upon execution; thus, a borrower under a demand instrument has no legitimate expectation of continued financing. To demand repayment is not abusive; it is simply enforcing the express terms of the financing agreement."); *Chaitman*, n.6 *supra* , at P 4.03[1][b] (citing *Spencer Cos. v. Chase Manhattan Bank, N.A.*, 81 B.R. 194 (D. Mass. 1987) ; *Taggart & Taggart Seed, Inc. v. First Tenn. Bank Nat'l Ass'n*, 684 F. Supp. 230 (E.D. Ark.) , *aff'd without op.*, 881 F.2d 1080 (8th Cir. 1988) (holding the U.C.C.'s good faith requirement inapplicable to demand notes)).

(n22)Footnote 22. See n.4 *supra*.

(n23)Footnote 23. *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 760 (6th Cir. 1985) .

(n24)Footnote 24. See, e.g., *Reid v. Key Bank, Inc.*, 821 F.2d 9, 13-14 (1st Cir. 1987) (refusing to enforce the demand note because the loan documents were not consistent with the demand relationship); *Shaughnessy v. Mark Twain State Bank*, 715 S.W.2d 944, 950-52 (Mo. Ct. App. 1986) (finding a note was not really a demand note based on four factors: the note provided for an interest rate upon default; the note provided for payment on demand but if there was no demand the note was to be paid on a specified date; the trust and security agreements included events of default; and the note was extended by an agreement which did not refer to the word "demand").

(n25)Footnote 25. For a more extensive list of cases on this point, see *Chaitman*, n.6 *supra* , at P 4.03[1][b].

(n26)Footnote 26. See *Discretionary Financing*, n.12 *supra*, at p. 568 n.203 (citing *Carrico v. Delp*, 141 Ill. App. 3d 684, 490 N.E.2d 972 (1986) (rejecting claim for punitive damages); *Rigby Corp. v. Boatmen's Bank & Trust Co.*, 713 S.W.2d 517, 535-36 (Mo. Ct. App. 1986) (remedy for breach of good faith lies in contract therefore punitive damages are not recoverable)).

(n27)Footnote 27. *Chaitman*, n.6 *supra* , at P 4.04[2] (citing *Clayton v. Crossroads Equip. Co.*, 655 P.2d 1125 (Utah 1982) ; *Alaska Statebank v. Fairco*, 674 P.2d 288 (Alaska 1983)) ; see *Discretionary Financing*, n.12 *supra*, at 568 n.203 (citing *Southeast Bank, N.A. v. Atrio Consol. Indus., Inc.*, No. 85-1406 (Fla. Dist. Ct. App. 1985) (jury awarded debtor \$9 million in punitive damages and \$3 million in compensatory damage; case was settled for \$3 million)).

(n28)Footnote 28. For a discussion of this issue, see *Discretionary Financing*, n.12 *supra*, at 574.

(n29)Footnote 29. See *State Nat'l Bank of El Paso v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. Ct. App. 1984) .

(n30)Footnote 30. See *Discretionary Financing*, n.12 *supra*, at 574.

(n31)Footnote 31. See *Discretionary Financing*, n.12 *supra*, at 574.

(n32)Footnote 32. See *Fed. Deposit Ins. Corp. v. Linn*, 671 F. Supp. 547 (N.D. Ill. 1987) .

(n33)Footnote 33. See *K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752 (6th Cir. 1985) .

(n34)Footnote 34. See *id.*; but see *In re Teltronics Servs., Inc.*, 29 B.R. 139, 170 (Bankr. E.D.N.Y. 1983) (stating that "a creditor normally has an unqualified right to call a loan when due, to refuse to extend a loan for any cause or no

cause at all, and to lawfully enforce collection").

(n35)Footnote 35. *Discretionary Financing*, n.12 *supra*, at 583.

(n36)Footnote 36. *Id.* at 584.

(n37)Footnote 37. *See Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1351, 23 C.B.C.2d 1118, 1118 (7th Cir. 1990) (five days' notice of termination of financing was drafted into the loan agreement), *rehearing denied en banc*, 1990 U.S. App. LEXIS 18381 (7th Cir. Oct. 12, 1990) .

(n38)Footnote 38. *See K.M.C. Co. v. Irving Trust Co.*, 757 F.2d 752, 759 (6th Cir. 1985) (a lender who wishes to terminate financing is required by the obligation of good faith and fair dealing to give the debtor reasonable notice to seek alternate financing, "absent valid business reasons precluding [the lender] from doing so"); *see Discretionary Financing*, n.12 *supra*, at 584-85, for a discussion of what constitutes reasonable notice; *see Kham & Nate's Shoes No. 2, Inc. v. First Bank of Whiting*, 908 F.2d 1351, 1351, 23 C.B.C.2d 1118, 1118 (7th Cir. 1990) (contract provided for termination of financing on five days' notice, which the court presumably considered reasonable), *rehearing denied en banc*, 1990 U.S. App. LEXIS 18381 (7th Cir. Oct. 12, 1990) .

(n39)Footnote 39. *See K.M.C. Co.*, 757 F.2d at 763 (notice of termination was equivocal).



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CHAPTER 4 Representing the Lender

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P 4.05 Common Law Theories of Lender Liability.

Despite the fact that debtor-creditor relationships are often governed by statutory law, a sizable body of case law has arisen from traditional common law theories. At all stages of a workout, the lender should keep in mind some salient common law doctrines.ⁿ¹

In a financing relationship with a troubled debtor, the lender "must walk a fine line between taking legitimate steps to protect its business interests and facing liability for exerting too much control and influence over the debtor" and as a result, becoming liable under the "instrumentality doctrine,"ⁿ² becoming liable for perpetrating fraud upon other creditorsⁿ³ or becoming liable for interfering with the borrower's corporate governance.ⁿ⁴ These bases for liability are obviously relevant both to the lender that is trying to assess its exposure for past conduct and to the lender that wishes to avoid trouble during a restructuring.

[1] Fraud.

The court in *Geler v. National Westminster Bank* ("*Geler*")ⁿ⁵ articulated the traditional elements for a cause of action based upon New York common law fraud. The plaintiff must prove that the defendant (1) made a false statement of material fact; (2) knew the representation was untrue or made it with reckless disregard of its truth or falsity; (3) intended to deceive and induce the injured party to part with or refrain from obtaining something of value; (4) caused the plaintiff to take action in reliance thereon; and (5) caused damage to the plaintiff due to the plaintiff's justified reliance thereon.ⁿ⁶

[a] Defenses to Common Law Fraud Claims.

Most successful defenses to common law fraud claims challenge the existence of the representation, or the plaintiff's allegations of reliance or scienter.ⁿ⁷

[i] Absence of a Representation.

To be actionable under a fraud claim, a misrepresentation of a material fact must be proved.ⁿ⁸ Provision of a mere opinion, however, is not actionable. A New York appellate court in *Belgo Asian Diamond Cy. v. European American Bank & Trust Co.* ("*Belgo*")ⁿ⁹ refused to hold a bank liable for fraud when the bank described an account as "satisfactory" in response to an inquiry by potential creditors of the account holder. The court held that under the

circumstances, "the alleged false misrepresentations of fact [were] more properly characterized as an expression of mere 'opinion,' which is not actionable."¹⁰

[ii] Absence of Reasonable or Justifiable Reliance.

In *Compania Sud-Americana de Vapores v. IBJ Schroder Bank & Trust Co.*,¹¹ the court held that under New York law, access to material information bars claims of reliance on allegedly material misrepresentations.¹² In that case, Compania Sud-Americana claimed that IBJ Schroder had committed fraud by repeatedly converting foreign currency into dollars for Compania Sud-Americana accounts at a rate that was well above the interbank rate for such currency conversions that was allegedly promised by IBJ Schroder. The court held that Compania Sud-Americana could not have justifiably relied on representations of IBJ Schroder employees that a more favorable exchange rate was being given because Compania Sud-Americana had access to both relevant rates but failed to take advantage of that access.¹³

[iii] Absence of Detrimental Reliance.

In addition to being reasonable or justifiable, the reliance on misrepresentations alleged in a fraud action must be the proximate cause of the injury. The *Geler* case is instructive on the requirement that reliance be detrimental reliance. In that case, the plaintiffs' attempt to turn a breach of contract action into a fraud action failed. The Gellers charged NatWest with fraud when the bank refused to make payment on a certificate of deposit. The court held that the Gellers could not plead detrimental reliance because the failure of the Gellers to obtain funds allegedly due under the certificate of deposit was entirely due to the bank's refusal to pay. No reliance on alleged misrepresentations could be shown because the alleged fraud was not extraneous to the contract.

[iv] Absence of Scienter or Fraudulent Intent.

The *Compania Sud-Americana* case is also instructive with respect to the element of scienter or fraudulent intent. The court held in *Compania Sud-Americana* that there was no evidence of scienter because there was no evidence that IBJ Schroder did not intend to perform its alleged promises at the time they were made.¹⁴ Nonperformance alone will not lead to an inference of fraudulent intent under New York law.¹⁵ Instead, the plaintiff "must allege specific facts showing that the promisor intended not to honor his obligations at the time the promise was made."¹⁶ The record before the court in *Compania Sud-Americana* contained no evidence of intent to defraud at the time of the alleged promise to apply favorable rates and established that IBJ Schroder did provide favorable rates for the period 1979-1984.¹⁷ Based upon those two facts, the court found that, as a matter of law, Compania Sud-Americana had failed to prove scienter.¹⁸

[b] Fraud by Lender Upon Other Creditors.

Lenders commonly receive inquiries as to the creditworthiness of a borrower. Case law provides guidance as to how the lender should respond.

As a general rule, a lender has no duty to respond to credit inquiries,¹⁹ but if a lender decides to disclose information on a company's financial condition, the disclosure must be accurate and complete. In *Central States Stamping Co. v. Terminal Equipment Co.*,²⁰ Central agreed to purchase a \$200,000 machine from Terminal. Prior to the purchase, the president of Central requested information concerning Terminal's financial capabilities. As a result of this request, Central was referred to Terminal's bank.²¹

When Central explicitly asked if Terminal had maintained its commitment to the bank, Terminal's bank admitted that the borrower was undercapitalized²² but, nevertheless, provided assurances as to Terminal's financial condition. In reliance upon the bank's statements, Central sent Terminal a \$30,000 deposit and shortly thereafter sent Terminal an additional progress payment of \$20,000. Terminal never delivered the machine to Central. Ultimately, Terminal was adjudged bankrupt and Central brought suit against the bank for misrepresentation.

The Sixth Circuit held that the bank had a duty to disclose Terminal's shaky financial position. Specifically, the court held that once the bank volunteered information the bank should have disclosed that Terminal was in default on two of its loans.ⁿ²³ The ruling undoubtedly turned in part on the fact that the bank had profited directly from the creditor's actions.ⁿ²⁴ As a general rule, a court is more likely to impose liability on the lender when a lender is aware of another creditor's reliance upon its possession of superior knowledge of the borrower's financial condition and benefits from a non-disclosure of information to other creditors.

Commercial National Bank of Peoria v. Federal Deposit Insurance Corp. ⁿ²⁵ provides another example of a court holding a lender, Farmers, liable for its failure to fully disclose information to another loan participant, Commercial. Farmers and Commercial had a long-standing relationship whereby Commercial provided overline loans to Farmers' customers. Farmers contacted Commercial for the extension of a \$90,000 unsecured loan to one of Farmers' small manufacturing customers without disclosing that its customer had three months earlier laid off all its employees. Farmers represented that its customer needed the funds to complete a contract; in fact, the contract never existed. Farmers also failed to disclose that the loan proceeds were designated to offset the customer's large outstanding overdraft to Farmers.

When Farmers went into receivership and the customer was placed in involuntary bankruptcy by the FDIC, Commercial sued the FDIC as receiver on allegations of fraud. On appeal, the court found that Farmers had, through fraud, induced Commercial to extend credit. The proof of damage was sufficient to support the jury's verdict for Commercial. The court also concluded that, despite Commercial's financial sophistication, it had justifiably relied on Farmer's misrepresentations.

In a case that in some respects appears similar to *Commercial National Bank of Peoria*, the Eighth Circuit highlighted the importance of the underlying facts in reaching the opposite conclusion. In *Union National Bank of Little Rock v. Farmers Bank*,ⁿ²⁶ Farmers, the bank that had initially extended the loan to the Tucker Oil, provided Union National, the purchaser of a 100% participation in the loan, with the most recent financial statement available for Tucker Oil, which indicated that the borrower was in "sound shape." Approximately two months after Union National bought the loan, Tucker Oil released a current financial statement that indicated a serious erosion in its financial condition. When Tucker Oil defaulted on its loan and filed a voluntary petition of bankruptcy, Union National demanded that Farmers repurchase the note. When Farmers refused, Union National sued Farmers for common law and constructive fraud.

The Court of Appeals for the Eighth Circuit found that there was no actual fraud perpetrated upon Union National because Farmers did not make a representation that it knew or believed was false. Based upon Tucker Oil's financial statements and audits, Farmers had no reason to believe that Tucker Oil had financial problems. The court also rejected the constructive fraud claimⁿ²⁷ because it failed to find any "special circumstances which would make the doctrine [of constructive fraud] applicable to this arms-length transaction between two banks."ⁿ²⁸ Union National's failure to examine easily accessible information undercut its argument that it justifiably relied on Farmers' representations. The court stated, "[a]bsent such special circumstance, or affirmative fraud, a party must seek out the information it desires; it may not omit inquiry and examination and then complain that the other did not volunteer information."ⁿ²⁹

Similarly, the Court of Appeals for the Second Circuit, in *Aaron Ferer & Sons Ltd. v. Chase Manhattan Bank, N.A.* ("*Aaron Ferer*"),ⁿ³⁰ failed to find that Chase Manhattan fraudulently induced release of claims against it due to Chase Manhattan's alleged nondisclosure of information to one of its correspondent banks. The court found that breach of a duty to disclose constituting fraud has to arise either from a fiduciary relationship or unequal access to knowledge.

Chase Manhattan had established a lockbox collateral arrangement with its customer, Aaron Ferer & Sons Co. ("*Ferer-Omaha*") and received in the lockbox refunds due to that customer's subsidiary, Aaron Ferer & Sons Ltd. (London) ("*Ferer-London*"). In Ferer-Omaha's bankruptcy case, Ferer-Omaha, Ferer-London and William & Glyn's Bank Ltd. ("*WG Bank*"), a lender to Ferer-London, entered into a stipulation whereby (i) Ferer-Omaha admitted it had

converted, without intent, funds due Ferer-London and owing to WG Bank; (ii) WG Bank's \$9 million general unsecured claim against Ferer-Omaha was admitted; and (iii) \$358,000 held by WG Bank, that belonged to Ferer-Omaha and was claimed by WG Bank and Chase, was retained by WG Bank and used to set off its claim in the bankruptcy case.ⁿ³¹ In return for dropping its objection to the settlement and claim against the \$358,000, Chase Manhattan received a release from WG Bank.

Following the settlement, WG Bank and Ferer-London learned that Chase Manhattan had received refunds of \$522,000 from a supplier to Ferer-London and Ferer-Omaha. They began an action in federal court alleging, *inter alia*, that Chase Manhattan had misrepresented or concealed material facts in connection with the release.ⁿ³² The Second Circuit found that Chase Manhattan had no duty to disclose the lockbox arrangement to WG Bank because Chase Manhattan did not have a fiduciary relationship with the plaintiff bank or greater access to information.

The Second Circuit held that "[a] correspondent bank relationship, standing alone, does not create an agency relationship," and that, therefore, Chase Manhattan owed no fiduciary duty to the plaintiff bank to disclose all information relating to Chase Manhattan's collateral arrangements with its customer.ⁿ³³ In addition, absent any allegation of a relationship greater than the usual debtor-creditor interactions characterizing bank-customer relations, no fiduciary duty bound Chase Manhattan to the subsidiary as a result of a lending relationship.

The Second Circuit noted that, if a party with access to accurate information knows that a second party is acting on mistaken information, the first party owes a duty of disclosure to the second party. However, the Second Circuit found no such disparity of knowledge in the *Aaron Ferer* case. The court noted that the president of the parent had provided the same schedule of anticipated refunds to both Chase Manhattan and the plaintiff bank, and indicated that Chase Manhattan intended to claim refunds against transactions of the plaintiff bank with the subsidiary. In those circumstances, the plaintiff bank could not argue that there was a disparity of information imposing on Chase Manhattan a disclosure duty.

Moreover, although Chase Manhattan never volunteered to the plaintiff bank or the subsidiary disclosure of the lockbox and collateral account arrangement maintained with the parent, the court found that all such information either existed in the public record, "was not pursued by ... [the plaintiff bank], or was disclosed, at least in part, by Chase."ⁿ³⁴ The lockbox arrangement remained in effect after the parent entered bankruptcy, and was recorded as part of the public record pursuant to the parent's bankruptcy case.ⁿ³⁵

[c] Remedies.

Damages for fraudulent misrepresentation include compensatory damages in an amount equal to the loss suffered by the plaintiff as a result of the reliance on the misrepresentation.ⁿ³⁶

[2] Interference with Corporate Governance.

In many workouts, a lender will be tempted to seek changes in the borrower's business. Although motivated by a desire to limit its exposure, the lender cannot interfere too greatly in the governance of the borrower without risking claims. In order to avoid liability, the lender should focus on the appropriate limits to its intervention.

If a lender's behavior harms the borrower's business, the borrower or a trustee in bankruptcy may sue the lender for tortious interference with corporate governance. Liability for this tort typically arises from a lender's intrusion into the daily affairs of a borrower.

In *State National Bank of El Paso v. Farah Manufacturing Co.*,ⁿ³⁷ the court affirmed a jury verdict that the bank had tortiously interfered with the borrower's management. The court based its holding on the fact that the bank had installed bank representatives as chief executive officer and chairman of the board, forced Farah to resign from the board,

blocked Farah's supporters from election to the board while packing the board with its own supporters and financed the proxy litigation against Farah.

Similarly, in *Melamed v. Lake County National Bank*,ⁿ³⁸ the court held that there was sufficient evidence for a jury to find that the lender had tortiously interfered in the borrower's business. In *Melamed*, the lender had forced a fifty percent pay cut for the borrower's president, replaced the borrower's accountant with one chosen by the lender, required the lender's approval of all payments by the borrower, prepared a thirteen-point program to "help salvage whatever is possible"ⁿ³⁹ from the borrower and suggested that the landlord change the locks on the borrower's premises.

[3] Excessive Control/Mere Instrumentality/Alter Ego Doctrines.ⁿ⁴⁰

[a] Generally.

At some point, a lender may exert such extensive control over a borrower that the lender's identity merges with that of the borrower. A lender that does so can become responsible as a principal for the borrower's obligations to third parties. Moreover, if the lender becomes the borrower's alter ego, the lender assumes the fiduciary duty to operate the borrower's business in the best interests of its shareholders and can be liable for negligence or mismanagement in violation of this duty. The prudent lender will stay far away from assuming such liabilities.

The threshold of control needed to trigger such liability is understandably high. The lender must assume virtual day-to-day control over the borrower so that the borrower is little more than a mere instrument of the lender.

[b] Case Law Involving Excessive Control/Mere Instrumentality/Alter Ego.

A series of cases over several decades has made clear the high threshold needed to establish an alter ego relationship.

In *In re Prima Co.*,ⁿ⁴¹ the trial court imposed liability upon the lenders because the lenders exerted pressure upon the borrower to install an outside manager whose decisions were subject to the lenders' approval. The court determined that the borrower agreed to this management change because it feared that the lenders would terminate their financing otherwise.

The Court of Appeals for the Seventh Circuit reversed the trial court's decision because it found that the lenders did not exercise undue influence over the borrower. Even though the lenders had veto power over the borrower's decisions, the court found that they did not actively exercise this power. The court also found it significant that the borrower not only never complained about the manager's performance in running the business, but later independently gave the manager a new contract and failed to rescind the manager's contract after the discovery of the alleged undue influence.

Similarly, the court in *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*,ⁿ⁴² held that the evidence was insufficient for a jury to find that the debtor was an instrumentality of the lender. The court stated that "courts require a strong showing that the creditor assumed actual, participatory, *total* control of the debtor. Merely taking an active part in the management of the debtor corporation does not automatically constitute control, as used in the 'instrumentality' doctrine, by the creditor corporation."ⁿ⁴³ In *Krivo*, the lenders had sent a manager to oversee the debtor's finances and to establish control procedures. The manager's approval was required for all outgoing purchase orders and his signature was required for all of the debtor's checks.

In a workout, lenders may have even wider latitude in monitoring a debtor's activities before risking excessive control liability. When the borrower runs into trouble, the lender may exercise limited oversight over the debtor's expenditures for the purpose of protecting the loan and keeping the borrower in business. In *Valdes v. Leisure Resource Group, Inc.*,ⁿ⁴⁴ the lenders entered an interim workout agreement with the borrower in which they agreed to advance additional funds of up to \$60,000 per month to pay, "in their unilateral discretion," the borrower's overhead expenses.ⁿ⁴⁵ The

lenders also established a lockbox account for the borrower's receivables.

When the borrower subsequently defaulted on a contract to purchase a hotel, the seller brought suit against the borrower and the lenders, asserting that the lenders were liable as the borrower's "alter ego." The seller claimed that the practical effect of the workout agreement, which committed the lenders to advance the borrower day-to-day operating expenses, was to render the borrower corporation a mere shell and a vehicle for the lenders' schemes. The Court of Appeals for the Fifth Circuit strongly disagreed with this characterization of the lenders' behavior and reversed a trial court verdict in favor of the plaintiff. "Even if the lenders approved each and every one" of the borrower's expenses, the court held, this was insufficient to establish their control over the borrower. Citing *Krivo*, the court stated that "the ability of a lender to monitor a debtor's expenditures ... represents a veto power which is negative in nature and when exercised in such a limited sense does not amount to domination or control."ⁿ⁴⁶

The court concluded that the claim against the lenders could not stand as a matter of law, since the lenders' actions "were confined to legitimate, limited controls for the purposes of protecting a multimillion-dollar loan package and attempting to keep [the borrower] in business."ⁿ⁴⁷

Even though a court may not ultimately find that a lender assumed actual, participatory and total control over the debtor, claims against lenders are time-consuming and expensive since the lenders may be forced to litigate against the borrower's claim of excessive control. In *Credit Managers Ass'n of Southern California v. Superior Court*,ⁿ⁴⁸ the assignee for the benefit of the creditors of the borrower sued the lender because the lender had threatened to foreclose on a \$210,000 note and "close down" the borrower unless the borrower hired a bank agent as a business consultant. The borrower claimed it unwillingly hired the consultant, who implemented strict policies regarding credit, sales and inventory and acted against the will of the directors and stockholders.

On appeal, the court reviewed the complaint, first noting that the consultant was alleged to have overruled and supplanted the board of directors and shareholders in the operation of the borrower's business. This was enough, the court held, for a trial court to conclude that the bank's agent owed a fiduciary duty to the borrower's shareholders and indirectly to the borrower's other creditors. The court further noted that the complaint "alleges, in effect, that as a proximate result of the management policies of ... [the consultant], in a relatively short space of time, ... [the consultant] reduced [the borrower] from a business entity with a fair market value of \$1,000,000 to a state of insolvency."ⁿ⁴⁹

[4] "Deepening Insolvency."

Some courts have suggested that the theory of "deepening insolvency"--a general term used to describe the fraudulent prolongation of a debtor corporation's life beyond insolvency--may also form the basis of a valid cause of action against lenders. In *Official Committee of Unsecured Creditors v. Credit Suisse First Boston (In re Exide Techs., Inc.)*,ⁿ⁵⁰ the Delaware bankruptcy court relied on the Third Circuit's decision in *Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co.* ⁿ⁵¹ to allow a committee of unsecured creditors to assert a "deepening insolvency" claim against a lender alleged to have (1) financed an acquisition in return for limited control over the debtor and (2) subsequently prolonged the insolvency of the debtor corporation by repeatedly suspending financial covenants in consideration for additional liens and guarantees just outside the 90-day preference period.ⁿ⁵² The crux of the "deepening insolvency" claim was that the lenders abused their control over the debtor "to force the Debtors fraudulently to continue its business for nearly two years at ever-increasing levels of insolvency ... [causing] the Debtors to suffer massive losses and become more deeply insolvent, costing creditors substantial value."ⁿ⁵³ The creditors' committee, the court ruled, had pleaded sufficiently to defeat the debtor's motion to dismiss.

Other courts, however, have criticized the view of "deepening insolvency" as a stand-alone theory of lender liability. In *Kittay v. Atlantic Bank (In re Global Services Group LLC)*,ⁿ⁵⁴ a Chapter 7 trustee brought a deepening insolvency claim against the debtor's main pre-petition lender for allegedly continuing to lend money to the debtor despite knowing the debtor was insolvent and undercapitalized. The trustee contended that by continuing to make these loans, the lender

improperly prolonged the corporate life of the debtor, to the detriment of unsecured creditors.

The *Global Services* opinion noted that courts have used the term "deepening insolvency" in different contexts, sometimes with different legal significance. While the *Lafferty* decision appears to treat "deepening insolvency" as a separate tort, most other courts have considered it in the more limited context of measuring damages.ⁿ⁵⁵ In adopting the damages theory and dismissing the trustee's claim, the court held that simply making a loan, by itself, cannot give rise to a tort:

This may be bad banking, but it isn't a tort. A third party is not prohibited from extending credit to an insolvent entity; if it was, most companies in financial distress would be forced to liquidate.ⁿ⁵⁶

The Court further noted that the separate tort theory of deepening insolvency relies on the faulty assumption that there exists an absolute "duty to liquidate." Such a duty is not found in the common law business judgment rule and is eschewed by the Bankruptcy Code, which encourages reorganization and preservation of enterprise value.ⁿ⁵⁷

In most jurisdictions, simply lending money to an insolvent debtor should not, by itself, give rise to lender liability for "deepening insolvency." Courts following the reasoning of *Global Services* will require an underlying tort, such as fraud or breach of an otherwise existing duty, before using deepening insolvency as a damages metric. However, the *Lafferty* decision suggests that some courts may be more willing to impose a duty on lenders not to lend money to debtors that are teetering on the brink of financial collapse. Accordingly, lenders should deliberate carefully before extending credit to an insolvent debtor and ensure that there is no suggestion that the loan proceeds will be used for any fraudulent or otherwise illegitimate purpose.

[5] Risk Minimization.

A lender can take steps to reduce claims of improper control. For example, an asset-based lender may require that all receivables be sent to a lockbox, which the lender controls. If honestly handled, the lockbox arrangement should not subject the lender to liability.

The lender may see an opportunity to improve its position by honoring overdrafts to certain creditors and not honoring others. The lender should avoid this temptation because it may be seen as participation in day-to-day operating management.

If the lender decides to offer financial and management advice to rehabilitate the debtor, the lender should only make suggestions regarding the debtor's financial management; ultimatums may result in liability.ⁿ⁵⁸ The lender might include a management change clause in the workout agreement, especially when current management is considered crucial to the lender's credit decision, in order to ensure that the lender can accelerate the loan if it is unhappy with the proposed new management.

The lender may also recommend a financial consultant or crisis manager to the borrower but, to avoid the appearance of control, the lender should not insist on a particular consultant and, in most instances, the consultant should be employed by the company and not by the lender.ⁿ⁵⁹ The lender can insist that the consultant issue reports to the lender on the company's financial condition and plans, but the company should have full knowledge of the contents of the reports. Finally, neither the creditor's financial personnel nor a consultant should usurp the debtor's ultimate authority to make its own financial decisions.

FOOTNOTES:

(n1)Footnote 1. H. Chaitman, *The Law of Lender Liability*, P 5.01 (WGL 1990) ["Chaitman"].

(n2)Footnote 2. Note, *K.M.C. Co. v. Irving Trust Co.: Discretionary Financing and the Implied Duty of Good*

Faith, 81 Nw. U. L. Rev. 539, 573 (1987) ["Discretionary Financing"]. See also P 4.05[3] *infra*.

(n3)Footnote 3. See P 4.05[1][a] *infra*.

(n4)Footnote 4. See P 4.05[2] *infra*.

(n5)Footnote 5. 770 F. Supp. 210 (S.D.N.Y. 1991) (citations omitted); see also *Commercial Nat'l Bank of Peoria v. Fed. Deposit Ins. Corp.*, 131 Ill. App. 3d 977, 980, 476 N.E.2d 809, 813 (Ill. App. Ct. 1985) (citing similar elements under Illinois law).

(n6)Footnote 6. *Geler*, 770 F. Supp. at 212-13 (S.D.N.Y. 1991) .

(n7)Footnote 7. See, e.g., *Stuart v. Tomasino*, 148 A.D.2d 370, 539 N.Y.S.2d 327 (N.Y. App. Div. 1st Dep't 1989) (dismissing fraud action for failure to show that lender made the representation and that borrower relied on alleged misrepresentation); *Compania Sud-Americana de Vapores S.A. v. IBJ Schroder Bank & Trust Co., S.A.* ("*Compania Sud-Americana*"), 785 F. Supp. 411, 419 (S.D.N.Y. 1992) (granting lender's motion for summary judgment due to borrower's failure to establish justifiable reliance or scienter). The court in *Compania Sud-Americana* stated that "[b]oth the Second Circuit and New York state courts have recognized the principle that access [to material information] 'bars claims of reliance on misrepresentations.'" *Id.* (citing *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 737 n.13 (2d Cir. 1984)) . With respect to scienter, courts have generally required the borrower to establish that the lender intended not to perform at the time of the representation, not merely that the lender failed to perform. Evidence of the latter will not automatically prove the former. See also *Nat'l Westminster Bank v. Ross*, 130 B.R. 656, 664 (S.D.N.Y. 1991) , *aff'd sub nom. Yaeger v. Nat'l Westminster*, 962 F.2d 1 (2d Cir. 1992) .

(n8)Footnote 8. *Metal Trading Servs., Inc. v. Trans-World Servs., Inc.* 781 F. Supp. 1539, 1544 (D. Kan. 1991) .

(n9)Footnote 9. 168 A.D.2d 345, 562 N.Y.S.2d 668 (N.Y. App. Div. 1st Dep't 1990) .

(n10)Footnote 10. 168 A.D.2d at 345, 562 N.Y.S.2d at 669 (N.Y. App. Div. 1st Dep't 1990) . Generally, "whether a statement is one of opinion or material fact is a jury question, although if it is clearly an expression of opinion so that a party should not rely upon it as a statement of fact it may be decided as a matter of law." *Metal Trading Servs. of Colorado, Inc. v. Trans-World Servs.*, 781 F. Supp. at 1545 (citing *Goff v. American Sav. Ass'n of Kansas*, 1 Kan. App. 2d 75, 561 P.2d 897, 902 (1977)) .

(n11)Footnote 11. 785 F. Supp. 411 (S.D.N.Y. 1992) .

(n12)Footnote 12. 785 F. Supp. 411, 419 (S.D.N.Y. 1992) (citing *Grumman Allied Indus., Inc. v. Rohr Indus., Inc.*, 748 F.2d 729, 737 n.13 (2d Cir. 1984)) . Whether reliance was reasonable or justified is a "factual determination to be made in light of the totality of the circumstances." *In re Ledford*, 970 F.2d 1556, 1560 (6th Cir. 1992) , *cert. denied*, 507 U.S. 916, 113 S. Ct. 1272, 122 L. Ed. 2d 667 (1993) .

(n13)Footnote 13. *Compania Sud-Americana de Vapores*, 785 F. Supp. at 419-20 . The interbank foreign exchange rates were available in daily newspapers received by Compania Sud-Americana. The rate offered by IBJ Schroder was confirmed in writing to Compania Sud-Americana. Also, Compania Sud-Americana could have discovered the alleged misrepresentations merely by calling other banks and obtaining quotations.

(n14)Footnote 14. *Id.* at 421 .

(n15)Footnote 15. *Id.* at 421 .

(n16)Footnote 16. *Nat'l Westminster Bank v. Ross*, 130 B.R. 656, 664 (S.D.N.Y. 1991) , *aff'd sub nom. Yaeger v. National Westminster*, 962 F.2d 1 (2d Cir. 1992) (citing *Songbird Jet, Ltd. v. Amax, Inc.*, 581 F. Supp. 912 (S.D.N.Y. 1984) , *aff'd*, 812 F.2d 713 (2d Cir. 1987)) .

(n17)Footnote 17. 785 F. Supp. at 421 .

(n18)Footnote 18. *Id.* at 422 .

(n19)Footnote 19. In a common law claim based on breach of an alleged duty to disclose, a district court held that the lead lender selling participation interests has no duty to disclose the creditworthiness of the borrower to the potential participants if the governing contractual participation agreement imposed no such duty. *Banco Espanol de Credito v. Sec. Pac. Nat'l Bank*, 763 F. Supp. 36, 44 (S.D.N.Y. 1991) , *aff'd*, 973 F.2d 51 (2d Cir. 1992) , *cert. denied*, 509 U.S. 903, 113 S. Ct. 2992, 125 L. Ed. 2d 687 (1993) . In *Banco Espanol*, there was no allegation of fraud; the claim was essentially for breach of fiduciary duty. The court cited *First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A.*, 919 F.2d 510 (9th Cir. 1990) for the proposition that fiduciary duties among loan participants depend upon the terms of their contract. The Southern District concluded that "in the context of loan participation agreements among sophisticated lending institutions, we are of the opinion that fiduciary relationships should not be inferred absent unequivocal contractual language Banks and savings institutions engaged in commercial transactions normally deal with one another at arms' length and not as fiduciaries." 763 F. Supp. at 45 (citing *First Citizens Fed. Sav. & Loan Ass'n v. Worthen Bank & Trust Co., N.A.*, 919 F.2d 510, 513 (9th Cir. 1990)) . See also *Aaron Ferer & Sons, Ltd. v. Chase Manhattan Bank, N.A.*, 731 F.2d 112, 122 (2d Cir. 1984) ("[A] correspondent bank relationship, standing alone, does not create [a fiduciary] relationship.").

(n20)Footnote 20. 727 F.2d 1405 (6th Cir. 1984) .

(n21)Footnote 21. Because Terminal was heavily indebted to the bank, the bank had assumed a supervisory role over the debtor's day-to-day management.

(n22)Footnote 22. *Central States Stamping*, 727 F.2d at 1407 .

(n23)Footnote 23. *Id.* at 1408-09 .

(n24)Footnote 24. The bank applied Central's \$30,000 deposit to Terminal's account to reduce Terminal's debt to the bank.

(n25)Footnote 25. 131 Ill. App. 3d 977, 476 N.E.2d 809 (Ill. App. Ct. 1985) .

(n26)Footnote 26. 786 F.2d 881 (8th Cir. 1986) .

(n27)Footnote 27. Under this doctrine, Union sought to make Farmers responsible for its misstatements even if Farmers did not know the statements were false "but made them with insufficient information." 786 F.2d at 886 .

(n28)Footnote 28. *Id.* at 886 .

(n29)Footnote 29. *Id.* at 887 .

(n30)Footnote 30. 731 F.2d 112 (2d Cir. 1984) .

(n31)Footnote 31. *Id.* at 119 .

(n32)Footnote 32. *Id.*

(n33)Footnote 33. *Id.* at 122 .

(n34)Footnote 34. *Id.* at 123 .

(n35)Footnote 35. 731 F.2d 112, 124 (2d Cir. 1984) . A different result was reached in *Metal Trading Servs. of*

Colorado, Inc. v. Trans-World Servs., Inc., 781 F. Supp. 1539 (D. Kan. 1991) ("Metal Trading"), where a Kansas district court found that there were material issues of fact, which precluded summary judgment, as to whether the defendant bank knowingly made false statements to trade creditors of a company that was a customer of the bank. In that case, two unpaid creditors sued a lender as a result of a six or seven minute conversation each had with a bank officer concerning possible business relationships with one of the bank's long-term customers. At the time of those conversations, the bank officer was unaware that an officer of the customer had falsified financial statements and copies of tax returns provided to the bank.

The court in *Metal Trading* denied the bank summary judgment on the fraud claim because of questions raised concerning the extent of the defendant bank's knowledge of the company's true financial condition at the time of the bank's conversation with the plaintiffs. The court found that the company had missed a few installment payments on loans from the bank; the bank had restructured all of the company's outstanding loans and received collateral, including the company president's home, his parents' home and his wife's personal guaranty, for those loans; and the bank knew that the company had lost its only customer for a major product line. The court also deemed the bank's statements concerning the company to be ones to "which reasonable companies considering doing business with a customer of the bank would attach importance," and hence, not merely opinions. 781 F. Supp. at 1545. In addition, the court held that "having undertaken to provide the plaintiffs with information regarding [the company's] ... financial status, the bank had a duty not to make any material misrepresentations." *Id.* The court noted that a party concealing or suppressing knowledge generally will not be liable for damages resulting from those omissions absent the receipt by that party of some advantage from the omissions. The bank argued that, as it had security interests in all the company's collateral, it had received no advantage from the detrimental reliance of the plaintiffs. The court found, however, that "it is not an unreasonable conclusion that the bank's position [... as lender with a security interest in all of the company's ... inventory and accounts receivable ...] may have improved with the additional inventory shipped by the plaintiffs." *Id.*

(n36)Footnote 36. *Chaitman*, n.1 *supra*, at P 5.05 [7] (citing *Commercial Nat'l Bank of Peoria*, n.25 *supra*).

(n37)Footnote 37. 678 S.W.2d 661, 690 (Tex. Ct. App. 1984).

(n38)Footnote 38. 727 F.2d 1399 (6th Cir. 1984).

(n39)Footnote 39. 727 F.2d 1399, 1404 (6th Cir. 1984).

(n40)Footnote 40. Although there might be technical differences among these three theories of liability, they are often used interchangeably by the courts and will be so used throughout this discussion.

(n41)Footnote 41. 98 F.2d 952 (7th Cir.), *cert. denied*, 305 U.S. 658, 59 S. Ct. 358, 83 L. Ed. 426 (1938).

(n42)Footnote 42. 483 F.2d 1098 (5th Cir. 1973).

(n43)Footnote 43. 483 F.2d 1098, 1105 (5th Cir. 1973) (emphasis added); *see also Ford v. C.E. Wilson & Co.*, 129 F.2d 614 (2d Cir. 1942), in which the lender's conduct was insufficient to hold the bank liable as a principal for the borrower's debts. In *Ford*, the lender required the borrower to get the lender's countersignature on all checks as a condition for an additional loan.

(n44)Footnote 44. 810 F.2d 1345 (5th Cir. 1987).

(n45)Footnote 45. *Id.* at 1355.

(n46)Footnote 46. *Id.* The court also noted the absence of any objective indicia of alter ego status or any evidence that trade creditors were unfairly treated during the period in which the lenders exercised oversight authority. Although conceding that the wisdom of the lenders in advancing additional loans to the troubled company may have been questionable, the court found "no evidence that in their administration, the loans were intended to or did usurp daily

management decisions regarding [the borrower]."

(n47)Footnote 47. *Id.*

(n48)Footnote 48. *51 Cal. App. 3d 352, 359, 124 Cal. Rptr. 242, 246 (Cal. Ct. App. 2d Dist. 1975) .*

(n49)Footnote 49. *51 Cal. App. 3d at 361, 124 Cal. Rptr. at 247 .*

(n50)Footnote 50. *299 B.R. 732 (Bankr. D. Del. 2003) .* The holding in *Exide* that a claim of "deepening insolvency" as a stand-alone tort is cognizable under Delaware law has been effectively overturned by subsequent decisions of Delaware courts. In *Trenwick America Litigation Trust v. Ernst & Young, L.L.P.*, 906 A.2d 168, 2005 (Del. Ch. 2006), the court held that an independent cause of action for deepening insolvency does not exist under Delaware law. Instead, the court noted that actions may be brought for a breach of fiduciary duty or fraud. *Id.* The court's decision in *Trenwick* was subsequently affirmed and adopted by the Delaware Supreme Court. See *Trenwick America Litig. Trust v. Billet*, 931 A.2d 438 (Del. 2007) . In the wake of *Trenwick*, at least one court has held that, under Delaware law, claims for breach of fiduciary duty, aiding and abetting a breach of fiduciary duty, corporate waste and civil conspiracy claims may still be asserted where the directors of an insolvent company wrongfully prolonged the company's existence and that deepening insolvency is a valid theory of damages for such a claim. See *Miller v. McCown De Leeuw & Co. (In re The Brown Schools)*, 386 B.R. 37 (Bankr. D. Del. 2008) .

(n51)Footnote 51. *267 F.3d 340 (3d Cir. 2001) .* In *Lafferty*, the Third Circuit held that accountants and underwriters that fraudulently induced an insolvent corporation to issue debt securities to investors and increase the company's leverage in a classic "Ponzi" scheme structure, could be liable under the theory of deepening insolvency under Pennsylvania law. The defendants in that case issued unqualified opinions that allegedly contained multiple fraudulent misstatements in furtherance of the Ponzi scheme. The court reasoned that (1) the "deepening insolvency" theory was sound, (2) courts were increasingly receptive to recognizing a distinct injury from prolongation of an insolvent debtor's existence, and (3) where an identifiable injury exists, the law must provide a remedy. *Id.* at 352 .

(n52)Footnote 52. *299 B.R. at 735 .*

(n53)Footnote 53. *Id.*

(n54)Footnote 54. *316 B.R. 451 (Bankr. S.D.N.Y. 2004) .* See also *Rafool v. Goldfarb Corp. (In re Fleming Packaging Corp.)*, 2005 Bankr. LEXIS 1740, *25-26 (Bankr. C.D. Ill. Aug. 26, 2005) ; *Trenwick Am. Litig. Trust v. Ernst & Young, L.L.P.*, 2006 Del. Ch. LEXIS 139, *103-05 (Del. Ch. Aug. 10, 2006) ; *In re CitX Corp.*, 448 F.3d 672, 677, 2006 U.S. App. LEXIS 13141, *10-11 (3d Cir. 2006) . Cf. *OHC Liquidation Trust v. Credit Suisse First Boston (In re Oakwood Homes Corp.)*, 340 B.R. 510, 528-31, 2006 Bankr. LEXIS 474, *39-47 (Bankr. D. Del. 2006) .

(n55)Footnote 55. *Id.* at 458 (reviewing cases).

(n56)Footnote 56. *Id.* at 459 .

(n57)Footnote 57. *Id.* at 460 .

(n58)Footnote 58. See *State Nat'l Bank of El Paso v. Farah Mfg. Co.*, 678 S.W.2d 661 (Tex. Ct. App. 1984) .

(n59)Footnote 59. Cf. *Krivo Industrial Supply Co. v. Nat'l Distillers & Chem. Corp.*, 483 F.2d 1098, 1108, 1110-12 (5th Cir. 1973) .



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CHAPTER 4 Representing the Lender

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P 4.05A Statutory Theories of Lender Liability.

[1] Generally.

Lenders face statutory liability for their lending activities both in and out of bankruptcy cases. Lenders face potential liability under numerous statutory frameworks, in particular, the federal securities laws and environmental laws. In addition, bankruptcy and insolvency laws relating to fraudulent conveyance, preference and equitable subordination claims are frequent methods for attacking the position of lenders.

[2] Liability Under the Federal Securities Laws.

A lender faced with participation in a restructuring should consider the securities law implications of its actions. If the lender is in "control" of the borrower, it is subject to joint and several liability for the borrower's securities law violations during the time of such "control."¹ "[P]ossession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting securities, by contract, or otherwise"² will result in "control" under the federal securities laws and may subject the lender to liability under those laws.³

Control person liability should not be triggered, however, unless a lender goes well beyond ordinary efforts to secure its loan or collect payment. In general, merely designating a director will not result in control person liability, and a lender will not be deemed to be a controlling person unless it actually becomes involved in overseeing a company's daily business affairs⁴ or management.⁵

[3] Lender Liability Under Federal Environmental Laws.

CERCLA poses the primary federal threat of environmental liability for lenders. Section 107 of CERCLA imposes liability for cleanup costs on any "person who at the time of disposal of any hazardous substance owned or operated any facility at which such hazardous substances were disposed of."⁶ This provision has been applied to lenders that have exercised operational management control over the company or foreclosed on property requiring environmental cleanup.⁷

CERCLA contains an exemption designed to provide a safe harbor for secured lenders, which excludes from the definition of "owner or operator" any person "who, without participating in the management of a vessel or facility holds

indicia of ownership primarily to protect its security interest in the vessel or facility."⁸ However, for years, there was confusion as to how to interpret "participation in management."

The now infamous *United States v. Fleet Factors Corp.* ⁹ decision, which held that a lender could lose the protection of the secured lender exemption by participating in management "to a degree indicating a capacity to influence the corporation's treatment of hazardous waste," sounded an early alarm for lenders. In the wake of the controversy generated by the *Fleet Factors* decision, the EPA, in April, 1992, issued a final rule attempting to clarify the meaning of the phrase "participation in management" and to set forth the circumstances under which the secured lender exemption would be available.¹⁰ The EPA rule provided a two-part test for determining what constitutes "participation in management," and gave a list of activities that would not, in and of themselves, be considered evidence of such participation.

Under the EPA rule, participation in loan workouts and monitoring activities before foreclosure would not have been deemed "participation in management" so long as the lender did not participate in management under the two-part test. Under the two-part test, a secured lender would have been considered to have participated in management to a degree sufficient to cause it to lose the secured lender exemption if it (i) exercised decision making control over the borrower's environmental compliance to the extent that it undertook responsibility for the borrower's hazardous waste disposal practices or (ii) assumed overall management responsibility encompassing the day-to-day decision making of the enterprise with respect to (A) environmental compliance or (B) substantially all of the operational aspects of the enterprise other than environmental compliance.¹¹ The EPA's rule on the secured lender exemption also specifically authorized a lender to foreclose, without CERCLA liability, if the lender took reasonable steps to divest itself of the property in a reasonably expeditious manner, including listing the property for sale within 12 months.¹²

The EPA rule provided greater certainty for secured lenders as to the scope of their possible liability.¹³ However, the United States Court of Appeals for the District of Columbia vacated the rule in its entirety,¹⁴ holding that the EPA lacked authority to promulgate legislative or interpretive rules defining or interpreting the liability of secured lenders under Section 107 of CERCLA.¹⁵

In response, Congress amended CERCLA with the passage of the Asset Conservation, Lender Liability and Deposit Insurance Protection Act of 1996.¹⁶ The Act largely adopted the EPA's lender liability rule and identified actions that if undertaken by a lender would not void CERCLA's secured creditor exemption. The Act also identified actions that a lender could take in connection with foreclosure without incurring liability under CERCLA.

The Asset Conservation Act largely adopted the EPA's test for "participation in management." Under the Act, a lender participates in management only if, while the borrower is in possession of the property, the lender (i) exercises decision making control over environmental compliance activities at a facility such that the lender has undertaken responsibility for hazardous substance handling or disposal practices at the facility, or (ii) exercises decision making control comparable to that of a manager of a facility so as to encompass day to day responsibility for environmental compliance of the borrower, or exercises control over "all or substantially all" of the borrower's operational functions regardless of whether these include environmental compliance activities.¹⁷ Addressing concerns raised by *Fleet Factors*, "participation in management" expressly excludes a lender's mere capacity to influence hazardous waste disposal practices of a borrower.¹⁸

The Act also created safe harbors to protect holders of a security interest that engage in activities commonly undertaken by lenders while they are policing a security interest or working out a loan prior to foreclosure. Thus, a lender may police the loan and require cleanup, require compliance with environmental laws and monitor and inspect the collateral.¹⁹ Similarly, lenders may provide financial or other advice to mitigate or prevent a default or diminution in the value of the collateral, may restructure or renegotiate terms of the security interest or exercise forbearance.²⁰

With respect to foreclosure and post-foreclosure activities, a lender will not be deemed an owner or operator under

CERCLA if after foreclosure the lender sells, liquidates or otherwise divests itself of the property "at the earliest practicable, commercially reasonable time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements."ⁿ²¹ After foreclosure, the lender may wind up operations or take other actions to prepare the property for sale without losing the secured creditor exemption.ⁿ²²

While CERCLA is the environmental law under which lender liability is most likely to be found, lenders must be aware that there are other federal and state environmental statutes under which a lender could be held liable.ⁿ²³ Most secured lenders will want to protect themselves from possible CERCLA liability (and liability under other environmental laws) when lending rather than after a borrower becomes troubled. Simple precautions when considering accepting security interests in real property, including performing due diligence regarding the history of the real property, requiring environmental site assessment where indicated, considering alternatives to accepting potentially contaminated property as collateral and negotiating appropriate environmental representations and warranties, as well as covenants providing for compliance with environmental laws and regulations, will be the initial bulwark against such liability.

FOOTNOTES:

(n1)Footnote 1. Section 20 of the Securities Exchange Act of 1934, 15 U.S.C. § 78t.

(n2)Footnote 2. Rule 405 of the Securities Act of 1933, 17 C.F.R. § 230.405(f) (1979).

(n3)Footnote 3. *SEC v. Coffey*, 493 F.2d 1304, 1318 (6th Cir. 1974) , cert. denied, 420 U.S. 908, 95 S. Ct. 826, 42 L. Ed. 2d 837 (1975) .

(n4)Footnote 4. See, e.g., *In re Falstaff Brewing Corp. Antitrust Litig.*, 441 F. Supp. 62 (E.D. Mo. 1977) .

(n5)Footnote 5. See *Tech. Exch. Corp. of Am., Inc. v. Grant County State Bank*, 646 F. Supp. 179 (D. Colo. 1986) . One circuit court has held, however that control person liability will not lie unless the debtor establishes that the lender (i) actually exercised control over operations of the borrower and (ii) possessed power to control the transaction that gave rise to the securities law violation. *Metge v. Baehler*, 762 F.2d 621 (8th Cir. 1985) , cert. denied, 474 U.S. 1057, 106 S. Ct. 798, 88 L. Ed. 2d 774 (1986) , and cert. denied, 474 U.S. 1072, 106 S. Ct. 832, 88 L. Ed. 2d 804 (1986) . But see *Brown v. Enstar Group, Inc.*, 84 F.3d 393, 397 (11th Cir. 1996) , cert. denied, 519 U.S. 1112, 117 S. Ct. 950, 136 L. Ed. 2d 838 (1997) (holding that "a defendant is liable as a controlling person under section 20(a) if he or she 'had the power to control the general affairs of the entity primarily liable at the time the entity violated the securities laws ...[and] had the requisite power to directly or indirectly control or influence the specific corporate policy which resulted in the primary liability' ") (quoting *Brown v. Mendel*, 864 F. Supp. 1138, 1145 (M.D. Ala. 1994)) .

(n6)Footnote 6. 42 U.S.C. § 9607(a)(2).

(n7)Footnote 7. See, e.g., *Ashland Oil, Inc. v. Sonford Prods. Corp.*, 810 F. Supp. 1057 (D. Minn. 1993) ; *United States v. Maryland Bank & Trust Co.*, 632 F. Supp. 573, 580 (D. Md. 1986) .

(n8)Footnote 8. 42 U.S.C. § 9601(20)(A).

(n9)Footnote 9. 901 F.2d 1550 (11th Cir. 1990) , cert. denied, 498 U.S. 1046, 111 S. Ct. 752, 112 L. Ed. 2d 772 (1991) , superseded by statute as stated in, *Monarch Tile, Inc. v. City of Florence*, 212 F.3d 1219, 1222, 2000 U.S. App. LEXIS 11676 (11th Cir. 2000) .

(n10)Footnote 10. Environmental Protection Agency Final Rule: National Oil and Hazardous Substances Pollution Contingency Plan; Lender Liability Under CERCLA, 57 Fed. Reg. 18344 (1992) .

(n11)Footnote 11. 57 Fed. Reg. 18383 .

(n12)Footnote 12. 57 Fed. Reg. 18344 .

(n13)Footnote 13. Decisions following the issuance of the EPA secured lender liability rule generally upheld the lender's right to the secured creditor exemption following application of the EPA's two-part test. *See e.g., Ashland Oil, Inc. v. Sonford Prods. Corp.*, 810 F. Supp. 1057 (D. Minn. 1993) ; *Kelley v. Tiscornia*, 810 F. Supp. 901 (W.D. Mich. 1993) .

(n14)Footnote 14. *Kelley v. E.P.A.*, 15 F.3d 1100 , *reh'g denied*, 25 F.3d 1088 (D.C. Cir. 1994) , *cert. denied sub nom. Am. Bankers Ass'n v. Kelley*, 513 U.S. 1110, 115 S. Ct. 900, 130 L. Ed. 2d 784 (1995) ; *Jostens, Inc. v. Vopak, Inc.*, 2003 U.S. Dist. LEXIS 9225 (D. Minn. 2003) .

(n15)Footnote 15. *Id.* at 1108 .

(n16)Footnote 16. 42 U.S.C. § 9601(20)(E)-(G).

(n17)Footnote 17. 42 U.S.C. § 9601(20)(F)(ii)(I) and (II).

(n18)Footnote 18. 42 U.S.C. § 9601(20)(F)(i)(II).

(n19)Footnote 19. 42 U.S.C. § 9601(20)(F)(iv).

(n20)Footnote 20. *Id.*

(n21)Footnote 21. 42 U.S.C. § 9601(20)(E)(ii)(II).

(n22)Footnote 22. 42 U.S.C. § 9601(20)(E)(ii)(II).

(n23)Footnote 23. The federal Resource Conservation and Recovery Act of 1976, for example, contains a lender liability exemption that shields lenders with security interests in petroleum underground storage tanks. *See* 42 U.S.C. § 6991b(h)(9).



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CHAPTER 4 Representing the Lender

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P 4.06 Fraudulent Conveyances.

[1] Generally.

Transfers that are prejudicial to creditors may be challenged under either the Bankruptcy Code provisions governing comparable state fraudulent conveyances or transfer provisions. As amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, *Section 548(a) of the Bankruptcy Code*¹ enables a trustee² to avoid a fraudulent transfer that occurred within two years of the filing of a petition under the Bankruptcy Code.³ Further, certain transfers made to a self-settled trust or similar device for the benefit of the debtor, if made with actual intent to hinder, delay, or defraud present or future creditors, will be voidable in bankruptcy for up to ten years after the transfer.⁴ Other amendments to Section 548 are intended to limit excessive pre-petition bonus or severance payments made to executive employees of a debtor.⁵ In addition to section 548 and other specific Bankruptcy Code provisions relating to the avoidance of transfers, bankruptcy trustees may avoid "any transfer of an interest of the debtor in property ... that is voidable under applicable [state] law by a creditor... ." ⁶

The fraudulent transfer or conveyance statutes of most states are based on the Uniform Fraudulent Conveyance Act ("UFCA") or the Uniform Fraudulent Transfer Act ("UFTA").⁷ The UFCA was enacted in 1918 to clarify the requirements for establishing intent to defraud in fraudulent conveyance cases. The intentional fraud provisions of the UFCA declare as fraudulent every conveyance "incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors."⁸ The UFCA codified some of the "badges of fraud"⁹ or particular circumstances to which courts looked, prior to the enactment of the UFCA, to presume fraudulent intent. With those provisions, the UFCA permits the avoidance of a transfer on a showing of constructive fraud.¹⁰ Generally, under the UFCA, constructive fraud arises where a transfer is made for insufficient consideration, and impairs the financial condition of the transferor.

The UFTA, a 1984 revision of the UFCA, retained the basic structure of the UFCA. In particular, the UFTA incorporated the UFCA's distinction between intentional and constructive fraud.¹¹

The three separate regimes established by the Bankruptcy Code, the UFCA and the UFTA to attack fraudulent conveyances are substantially similar. Each finds a fraudulent conveyance where there is actual intent to hinder, delay or defraud creditors. Further, under each of the Bankruptcy Code, the UFCA and the UFTA, constructive fraud will be found to exist where the debtor did not receive a fair consideration and (i) was insolvent at the time of the conveyance;

(ii) was rendered insolvent as a result of the transfer; (iii) was left with unreasonably small capital as a result of the transfer; or (iv) intended or believed that it would incur debts it could not pay.

Although substantially similar, the Bankruptcy Code, the UFCA and the UFTA differ in some important respects. As noted above, *section 548 of the Bankruptcy Code* contains a two-year statute of limitations for avoiding fraudulent conveyances in cases commenced on or after April 21, 2006 (and, with respect to certain transfers made to asset protection trusts, a ten-year statute of limitations). Trustees will still often elect to use *section 544(b) of the Bankruptcy Code*,ⁿ¹² in order to utilize the longer statutes of limitation found in applicable state statutes.ⁿ¹³ Further, a trustee may opt to use state law rather than section 548 to challenge a transaction as a fraudulent conveyance because a particular state's law may alter burdens of proof or give other strategic advantages in litigation of a fraudulent conveyance.

Another major difference between the UFCA, on the one hand, and the UFTA and the Bankruptcy Code, on the other, relates to the test for fair consideration. Under the UFCA, the test of fair consideration requires that the transferee in good faith gives a "fair equivalent," and as such fair equivalent, property is conveyed or an antecedent debt is satisfied. Under the UFTA and *section 548(a)(1)(B)(i) of the Bankruptcy Code*, the test is limited to whether the transferor received "reasonably equivalent value."

The significant difference between "fair equivalent" and "reasonably equivalent value" is that the latter does not contain a "good faith" component. The UFTA and the Bankruptcy Code eliminate the issue of good faith of the transferee when looking at the adequacy of consideration exchanged for a transfer or obligation. In constructive fraud cases, good faith is relevant only when the transferee, as a defense, demonstrates that it is entitled to protection to the extent of value given despite the failure of the debtor to receive a reasonably equivalent value.

Another difference between the UFTA and the UFCA concerns their respective treatment of transactions involving the grant of a security interest. Section 3(b) of the UFCA provides that, when the transfer involves the grant of a security interest, the "fair consideration" required is an "amount not disproportionately small as compared with the value of the property, or property obtained." As at least one commentator has noted, under the UFTA, if there is equity in an asset over the debt secured by the asset, there is no fraudulent conveyance absent circumstances suggesting an intent to defraud.ⁿ¹⁴

[2] In the Context of Leveraged Buyouts.

Failed leveraged buyouts ("LBOs") have left many LBO lenders scrambling to assess their potential advantages or vulnerabilities in the context of any proposed restructuring. Often, this assessment involves a close review of potential fraudulent conveyance or transfer claims and liabilities.

Troubled LBOs have proved fertile ground for claims of constructive fraud against lenders.ⁿ¹⁵ⁿ¹⁶ By its nature, an LBO involves transactions in which a company's assets are pledged to lenders in exchange for a loan used to purchase stock from selling shareholders. Courts have found that the debtor itself must receive the required value; it is irrelevant that a selling shareholder or another third party received value.ⁿ¹⁷

This section focuses its discussion of fraudulent conveyances on LBOs as an illustration of the application of fraudulent conveyance laws to sophisticated corporate transactions. It begins with a brief discussion of the bases for applying fraudulent transfer laws to LBOs, the elements of a fraudulent conveyance and choice of law considerations. It follows with an outline of the use of fraudulent conveyance statutes to attack LBOs.

[3] Collapsing LBO Transactions.

Many LBOs are structured with an acquisition vehicle established to borrow money to finance the purchase of a target company. When a tender offer for the target is completed, the acquisition vehicle and the target merge. Viewed

separately, neither transaction results in a fraudulent conveyance. In the first step, money is loaned to the acquisition company for the purchase of stock of a separate company. At that time, the target company does not acquire any new debt. Yet, when the tender and the merger are "collapsed," and viewed as one transaction, it is clear that the target is incurring debt to purchase its own stock.

[a] *Wieboldt*.

In *Wieboldt Stores, Inc. v. Schottenstein*, the court rejected the contention of insider shareholders and LBO lenders that they were exempt from a fraudulent conveyance attack because they did not receive property of the borrower in a tender offer. In reaching its conclusion, the *Wieboldt* court relied on the decision of the Court of Appeals for the Third Circuit's in *United States v. Tabor Court Realty Corp. ("Gleneagles")*,ⁿ¹⁸ which established a rule allowing a court to collapse different steps in an LBO transaction in conducting a fraudulent conveyance analysis. In effect, the *Wieboldt* and *Gleneagles* courts recognized that an acquisition vehicle acts as a "mere conduit" for the transfer of the borrower/target's property in a tender offer when the acquisition of the target's stock is financed through an LBO.ⁿ¹⁹ Applying this analysis to the LBO at issue in *Wieboldt*, the court stated that the "formal structure of the transaction alone cannot shield the LBO lenders or controlling and insider shareholders from [the borrower's] fraudulent conveyance claims."ⁿ²⁰

In addition to permitting the steps in an LBO transactions to be collapsed, courts have given short shrift to the argument that a target company receives fair consideration in a typical LBO (*i.e.*, where the acquiring entity is a shell, or has little or no assets prior to the acquisition and the acquisition is largely financed by debt secured by the target company's assets). The target merely acts as a conduit for cashing out the selling shareholders.ⁿ²¹ Given this analysis, there is no opportunity for lenders, pre-LBO shareholders and other potential defendants to hide behind the formal structure of LBO to avoid fraudulent conveyance liability.ⁿ²²

[b] *Crowthers McCall Pattern, Inc v. Lewis*.

A fraudulent conveyance attack was launched in the bankruptcy of *Crowthers McCall Pattern, Inc.*,ⁿ²³ where an effort to reduce the risk of potential liability resulted in the LBO being consummated in a two-step process.

TLC Pattern, Inc. ("TLC Pattern") was sold at auction to the Crowthers Group. Initially Crowthers Group acquired TLC Pattern through GJS One, a thinly capitalized corporation formed to purchase the shares of the target company. GJS One paid \$63 million for TLC Pattern's stock, \$50 million of which was financed through bridge loans from two lenders, Shearson Holdings and Bankers Trust Company. Then TLC Pattern was merged into GJS One. Despite this structuring, the district court found that the debtor had adequately pleaded a fraudulent conveyance cause of action against the lender, Bankers Trust Company.ⁿ²⁴

With respect to the claims against Bankers Trust, the court collapsed the transactions and found that "the ultimate result ... was to impose additional debt of \$35 million on Crowthers Pattern, for which Crowthers Pattern received nothing in exchange."ⁿ²⁵ The court found that, even though the lender advanced the funds to GJS One, GJS One merely served as "a conduit for the transfer of the loan proceeds to the TLC Pattern shareholders." The court concluded that Crowthers Pattern had assumed the responsibility for repayment of the Bankers Trust loan without the receipt of any corresponding benefit.

[4] Elements of a Fraudulent Conveyance.

[a] Actual Fraud.

If actual fraud exists, a transfer is a fraudulent conveyance even if the transferor receives fair consideration and is not insolvent. As noted above, the UFCA's intentional fraud provision, section 7, declares fraudulent every conveyance "incurred with actual intent, as distinguished from intent presumed in law, to hinder, delay, or defraud either present or future creditors."ⁿ²⁶ Actual intent to defraud will be found even if the debtor's intent is not to deprive creditors of

ultimate payment, but merely to hinder or delay creditors so as to gain time.

Similar intentional fraud provisions are found in the Bankruptcy Code and the UFTA.ⁿ²⁷ The party alleging actual fraud under *section 548(a)(1) of the Bankruptcy Code* has the burden of proving such fraud by clear and convincing evidence.ⁿ²⁸

Gleneagles, where the Court of Appeals for the Third Circuit ultimately affirmed the avoidance of a lender's mortgages obtained in a leveraged buyout, is an instructive actual fraud case. There, the Third Circuit applied Pennsylvania's UFCA, and found that the debtor transferred properties as security with both an actual and constructive intent to hinder and delay its creditors.ⁿ²⁹

The district court in *Gleneagles* had held that granting mortgages to an LBO lender hindered and delayed other creditors by preventing the debtor from selling land even though such sales previously generated the necessary cash flow to service the debtor's debts. The LBO lender was charged with the knowledge that its borrower would otherwise have inadequate cash reserves to fund those debts because the LBO lender knew that (a) the borrower had enormous liabilities and (b) the LBO loan proceeds were being used to pay pre-LBO shareholders. The district court also found that the LBO lender knew the debtor would be rendered insolvent by the LBO loan because, absent the ability to sell property, the debtor would not be able to pay its other debts at maturity.ⁿ³⁰ Moreover, the district court found that the borrower was unable to service its debts because of its loan payments to the LBO lender and the restrictive covenants in the loan agreement. The district court concluded that these factors and the lack of fair consideration created an intentionally fraudulent conveyance under section 6 of the Pennsylvania UFCA, which was in effect at the time.ⁿ³¹ To place other creditors of the debtor in the position they would have been in prior to the LBO, the district court invalidated the lender's entire lien.ⁿ³²

[b] Constructive Fraud.

If actual intent to defraud creditors is not alleged or cannot be proven by the debtor, a transfer may be avoided as constructively fraudulent if (i) the transfer was made for less than fair consideration and (ii) the debtor was either insolventⁿ³³ at the time of the transfer or became insolvent as a result of the transfer or was involved in business with unreasonably small capitalⁿ³⁴ or intended to incur or believed it would incur debts beyond its ability to repay.ⁿ³⁵

[c] Lack of Fair Consideration.

Section 548 of the Bankruptcy Code provides that transfers may be avoided where the debtor received "less than reasonably equivalent value in exchange for such transfer."ⁿ³⁶ The UFCA provides that a transfer made without an intent to hinder, delay or defraud creditors is avoidable only if it was not made for fair consideration. Section 3 of the UFCA defines fair consideration as fair equivalent value given in good faith.

As noted above, LBOs raise fraudulent conveyance concerns because the target company, in the stock buy-back, does not receive consideration or value for the obligations it incurs. Pre-LBO shareholders of a target receive money for their shares but those shares, even if transferred to the target company, are worthless to the target company.ⁿ³⁷

In *In re O'Day Corp.*,ⁿ³⁸ the court found that certain transfers involved in the leveraged buyout of O'Day Corporation lacked fair consideration and resulted in the insolvency of the target. That case involved a chapter 7 trustee's application to avoid a bank's security interests. The *O'Day* court found that Meritor Savings Bank's 1987 financing of the O'Day's LBO resulted in a fraudulent conveyance.

In 1987, Meritor helped arrange the sale of O'Day to a third party, financed in part with loans from Meritor. At the closing, an affiliate's intercompany notes, which reflected obligations of a 1984 LBO and were attributable to O'Day's parent, Forstmann, Little & Co.,ⁿ³⁹ were assigned to O'Day and cancelled in connection with the 1987 LBO. O'Day

experienced financial turmoil in the fall of 1988 and ceased operations entirely in April, 1989.

The court found that the Meritor loan proceeds did not constitute reasonably equivalent value because they were passed through O'Day to its selling shareholders. The issue of fair consideration rested on the significance of the cancellation of the intercompany notes. The court found that the intercompany notes had been created only for tax purposes and their transfer did not constitute reasonably equivalent value.

Despite the initial ease with which courts found lack of fair consideration in LBO's, later cases have shown courts straining the bounds of those concepts to avoid finding that an LBO resulted in a fraudulent conveyance, suggesting a wariness in using fraudulent conveyance laws to successfully attack LBO's. In *Mellon Bank, N.A. v. Metro Communications, Inc.*,ⁿ⁴⁰ the Court of Appeals for the Third Circuit decided that the direct and indirect benefits a target receives from an LBO may have sufficient value to shield against fraudulent conveyance claims. In analyzing a fraudulent conveyance claim under *section 548 of the Bankruptcy Code*, the Third Circuit stated that the:

touchstone is whether the transaction conferred realizable commercial value on the debtor reasonably equivalent to the realizable commercial value of the assets transferred. Thus, when the debtor is a going concern and its realizable going concern value after the transaction is equal to or exceeds its going concern value before the transaction, reasonably equivalent value has been received.ⁿ⁴¹

The *Mellon* court emphasized that the determination of reasonably equivalent value should take into account all intangible assets and off-balance sheet items, including good will. The Third Circuit found that the bankruptcy court and district court erred in reviewing whether the target received reasonably equivalent value by not looking at the target's increased access to working capital and the synergistic value expected to result from the LBO.ⁿ⁴² In addition, *Mellon* held that the value of any contributions from co-guarantors should be factored into the value received by the debtor.

In effect, it appears that the Third Circuit will not presume, under *section 548 of the Bankruptcy Code*, that a transfer in an LBO was undertaken for less than reasonably equivalent value merely because the target did not retain for its own use the proceeds of the debt it incurred.ⁿ⁴³

[d] Insolvency.

An LBO transfer will be found to be a constructive fraudulent conveyance only if, at or immediately upon the transfer, the transferor was insolvent or undercapitalized.

The definitions of insolvency in the Bankruptcy Code, the UFCA and the UFTA differ slightlyⁿ⁴⁴ but are variations of a balance sheet test for insolvency where contingent assets and liabilities must be valued (but discounted appropriately). Despite these three definitions, the hallmarks of insolvency are not easily determined by reading the case law.

Although it is an issue in most cases, courts do not uniformly construe "insolvency."ⁿ⁴⁵ Sometimes courts refer to a balance sheet test and a "going concern" test in defining insolvency. The distinctions if any between these two "tests" are blurred. The better view is that where the company operates after the transfer as a going concern it is not appropriate to value the company on a liquidation or forced sale basis. Instead, the various valuation techniques used to measureⁿ⁴⁶ going concern should be employed. Liabilities, including contingent liabilities, would be subtracted from that valuation.ⁿ⁴⁷

Section 101 of the Bankruptcy Code defines insolvency as a "financial condition such that the sum of such entity's debtsⁿ⁴⁸ is greater than all of such entity's property, at a fair valuation ...".ⁿ⁴⁹ In determining insolvency, the book value of a company's assets is not controlling. Nor is the value determined by application of generally accepted accounting principles.ⁿ⁵⁰

The court in *In re Ohio Corrugating Co.* n51 interpreted the Bankruptcy Code's balance sheet test to include a cash flow concept. The *Ohio Corrugating* court rebuffed a fraudulent conveyance attack on an LBO, finding that the LBO did not cause the target's failure. The company's insolvency was attributed to a reduction in market prices, a decline in sales and an inability to borrow that was not associated with the LBO. The court based its decision on the successful operation of the target for several months after the LBO, finding it particularly significant that all trade accounts were paid six or seven times after the LBO. Although a reconstructed balance sheet showed that the debtor had a negative net worth of close to \$700,000 at the time of the LBO, the company's ability to pay its trade creditors for several months was found by the court to "believe the contention that this was a company which was in the throes of insolvency" at the time of the LBO.n52 A company that appears insolvent on a quick review of assets and liabilities on a balance sheet read may not appear insolvent when viewed as a going concern. When a company is viewed as a going concern, a determination may be made as to whether the capital structure of the company after a transfer was so over-leveraged that insolvency was inevitable.

In *Moody v. Security Pacific Business Credit, Inc.*,n53 the Third Circuit upheld as proper the district court's valuation of the debtor's assets on a going concern basis.n54 *Moody* involved a fraudulent conveyance claim under the Pennsylvania UFCA that was in effect at the time based on the LBO and subsequent bankruptcy of the Jeanette Corporation.n55 The district court had found that the LBO was without fair consideration, but that Jeanette was not rendered insolvent or left with unreasonably small capital as a result of the LBO.n56

On appeal, the plaintiff challenged the district court's solvency and capitalization analyses. Despite the plaintiff's argument that the valuation should be based on the current saleable value of the company's assets, some of which were possibly not liquid, the court found that where bankruptcy was not "clearly imminent" on the date of conveyance, the company's assets should be valued on a going concern basis. The Third Circuit agreed with the district court that Jeanette was not a company whose failure was clearly imminent at the time of the LBO, since it had a net worth of more than \$40 million and positive cash flow.

In addition to the various financial tests, a company's post-LBO performance may also be persuasive. In *In re Envirodyne Indus., Inc.*,n57 the court first considered several valuation methods, and then paused for a "reality check" consisting of "a study of how financial markets have reacted to a transaction."n58 The court observed that, after the LBO, the company's public debt "was traded by the general public at or near par" and that the company "was able to borrow funds from sophisticated financial institutions."n59 The fact that following the LBO the investing public "acted as if Envirodyne was and would remain a solvent company"n60 evidenced Envirodyne's post-LBO solvency. As background, the court noted that, seven months after the LBO, a corporation conducted extensive due diligence and purchased over \$2.7 million of the stock of Envirodyne's parent, and that Envirodyne did not default on any debt obligation until a year and a half after the LBO.n61

[e] Unreasonably Small Capital or Undercapitalization.

Unreasonably small capital is not defined in *section 548 of the Bankruptcy Code*,n62 the UFCA or the UFTA. In *In re Vahnais Lumber Supply, Inc.*, the court stated that "unreasonably small capitalization" was not the same as insolvency. It "encompasses difficulties which are short of insolvency in any sense but are likely to lead to insolvency at some time in the future." n63

To determine whether an LBO transaction rendered a company undercapitalized, courts look to the prudence and reasonableness of projections used in the transaction.n64 When making that determination, courts first look at the debtor's historical performance. That review is completed to get the benchmark by which to review the reasonableness of the projections. Historical performance is the benchmark of the analysis. The review of historical performance must, however, take into account any unusual events or factors that render the historical performance not indicative of the true state of the company. Care should be taken to make sure that the company did not have significant acquisitions or

dispositions during that period. If there were significant acquisitions or dispositions, adjustments should be made to the historical projections to permit a true comparison.

Next, courts compare the projected trends with the historically derived trends to determine whether the projected trends continue along the same lines as the historical trends.ⁿ⁶⁵ If the two sets of trends track each other, the question is: Was it reasonable to assume that the historical trends would continue, without change, or were there foreseeable events that would necessitate a change in the projected trends? For example, if a company is aware that a new competitor will shortly enter its market, it may be unreasonable to project sales growth rates at levels commensurate with historical trends.

On the other hand, if the projected trends differ from the historical trends, one must inquire into the reasonableness of the assumptions underlying those differences. For example, if projections show a sharp increase in sales, the rationale for that increased growth should be examined. If projections relied on increased asset sales to generate sufficient cash flow to pay future debts, is it reasonable to assume assets could be sold at the prices projected during the relevant time period?

After projections are compared with historical trends, they must be compared to actual performance. That examination should determine whether the company failed to meet the projections because those creating the projections used overly aggressive assumptions in that creation or because of the impact of events that were not foreseeable at the time the forecasts were created.ⁿ⁶⁶ Even if some discrepancies were not the result of reasonably unforeseeable events, the projections may still be deemed reasonable if there was sufficient financing (for example, in the form of available credit under a revolving credit agreement) available to cover such events.

[i] Cases Where Projections Deemed Reasonable.

One of the earliest decisions favorable to an LBO lender charged with involvement in a fraudulent conveyance was *Credit Managers Ass'n of Southern California v. the Federal Company*,ⁿ⁶⁷ where the court found that the LBO did not leave the target undercapitalized.ⁿ⁶⁸ The court admitted that the target did not receive fair consideration for the debt it incurred, and noted that the target was unable to service the LBO debt. Despite these factors, the court found that the cause of the target's failure was the occurrence of unforeseen business conditionsⁿ⁶⁹ and not the LBO.

Similarly, in *Moody*,ⁿ⁷⁰ the Court of Appeals for the Third Circuit refused to find that an LBO had resulted in a fraudulent conveyance. In addition to considering whether the LBO rendered Jeannette insolvent, in *Moody*, the Third Circuit assessed whether Jeannette was left with unreasonably small capital. The court stated that "[w]e cannot say that Jeannette was left with an unreasonably small capital merely because after the leveraged buyout its sole source of operating capital was its line of credit with [LBO lender]."ⁿ⁷¹ The court adopted the approach taken in *Credit Managers*, stating that LBO participants may be liable when it is reasonably foreseeable at the time of the transaction that the LBO will fail, but recognizing that businesses may fail for any number of reasons. "[T]he test for unreasonably small capital," the Third Circuit held, "is reasonable foreseeability."ⁿ⁷²

The *Moody* court relied on testimony of a lender official that the lender had no "incentive to make this loan if it believed that Jeannette would fail" since the lender had "received no up-front fees relating to this transaction."ⁿ⁷³ Nor did the district court find any evidence from which to conclude that the lender believed Jeannette would incur debts that were beyond its ability to pay as they matured. The court agreed with the district court that the two sets of one-year projections prepared in connection with the LBO were prudent and reasonable at the time prepared; a drastic decline in sales which led to the company's bankruptcy was due to increased foreign and domestic competition, rather than a lack of capital.

In *Envirodyne* the court examined in detail the LBO projections. Those projections generally assumed only modest improvements over historical performance, and included explanations for how those improvements were to be achieved.

Noting the experience of the team that prepared the projections and the existence of a favorable solvency opinion prepared immediately before the LBO, the court concluded that the projections "were reasonable and were based on assumptions that (1) were predicated on a factual and reasonable historical basis; (2) were complete and not misleading; (3) were advanced in good faith [by the LBO sponsors]; and (4) provided substantial margin for error and financial flexibility for Envirodyne."ⁿ⁷⁴ To explain how Envirodyne could end up bankrupt despite those encouraging projections, the court endorsed expert testimony attributing one-third of the company's cash shortfall to "overly aggressive forecasting," while attributing two-thirds to "unforeseeable post-LBO ... events, including among other events, the benzene [health scare] incident that adversely affected [a subsidiary's] sales in 1991, unforeseeable competitive market pressures and shortfalls in sales in 1989 and 1990, and unexpected increases in raw materials prices resulting from the Gulf War," as well as substantial capital expenditures not contemplated at the time of the LBO.ⁿ⁷⁵ In the court's view, it was these unforeseen events, not the LBO, that ultimately rendered Envirodyne unable to pay its debts.

[ii] Cases Where Projections Deemed Unreasonable.

In addition to finding that O'Day was insolvent at the time of the LBO under a balance sheet test,ⁿ⁷⁶ the *O'Day* court assessed the reasonableness of O'Day's capitalization following the LBO. The *O'Day* court adopted the approach taken in *Credit Managers*,ⁿ⁷⁷ assessing the sufficiency of working capital by determining whether the projections employed prior to the LBO were prudent. As in *Credit Managers*, the *O'Day* court did not examine what subsequently happened to the company. In reviewing the projections in a historical context, the court found that Meritor's projections were "totally inconsistent with the historical figures ... as well as the fiscal 1987 data that was available to them."ⁿ⁷⁸ In particular, the court found that:

- (i) EBIT and gross profit margin assumptions ignored historical averages and available fiscal 1987 results (the LBO occurred on June 30, 1987);
- (ii) the worst case scenario showed that the company "would somehow match or exceed [its] ... best financial performance of the 1980's";
- (iii) the earnings assumptions upon which the projections were based were unreasonable and, therefore, the projections themselves were unreasonable; and
- (iv) labor problems, cost variance and cyclicity in the industry, which were major contributors to O'Day's financial problems, were predictable prior to the LBO.ⁿ⁷⁹

The *O'Day* court also found it utterly incredible that the bank's worst case scenario assumed that "O'Day would somehow match or exceed its *best* financial performance of the 1980's."ⁿ⁸⁰ The *O'Day* court distinguished *Credit Managers* on its facts because Meritor's projections were imprudent whereas the projections in *Credit Managers* were reasonable.ⁿ⁸¹

Similarly, the examiner in *Revco* found that the LBO left Revco with unreasonably small capital with which to conduct its business and meet its existing debt obligations.ⁿ⁸² In reaching this conclusion, the examiner considered the reasonableness of Revco's projections at the time of the LBO in light of Revco's working capital requirements and the lender's analysis of Revco's financial health. The examiner found that Revco's projections at the time of the LBO were unreasonable. The examiner determined that both the "reasonable" and "worst case" scenarios suggested that Revco would not be able to service its debt. In addition, serious cash flow problems were documented less than one month after Revco's LBO.

[5] Choice of Law.

Identification of the state with the most interest in the transaction at issue is the first step in determining which state fraudulent conveyance law to apply to any transaction, including an LBO.ⁿ⁸³ In this very fact specific review, a court weighing which state's fraudulent conveyance law to apply to a transaction would pay particular attention to the location of:

- the principal place of business and corporate headquarters of the company at issue;
- all relevant meetings and telephonic communications at issue in the transaction;
- meetings and/or discussions affecting the structure and implementation of the transaction at issue;
- meetings between the company and any member of the relevant lending group; and
- the completion of a substantial portion of the due diligence work of the lenders.

[6] Fraudulent Conveyance Claims Against Participants in an LBO.

Once a transfer is avoided, the party or parties that may be liable are delineated under *section 550 of the Bankruptcy Code*. *Section 550(a) of the Bankruptcy Code* permits a debtor to recover property transferred or, if so ordered, the value of the transferred property from an initial transferee or intended beneficiary, or any immediate or mediate transferee of an initial transferee.ⁿ⁸⁴

Section 550(b) applies to the determination of liability for transferees other than the initial transferee. Under section 550(b), the debtor in possession or trustee may not recover from any immediate or mediate transferee of an initial transferee if the subsequent transferee takes "for value, including satisfaction or securing of a present or antecedent debt in good faith, and without knowledge of the voidability of the transfer avoided."

Even where liability for a fraudulent conveyance may be imposed on a number of possible defendants, only a single satisfaction may be recovered. Thus, although LBO lenders and pre-LBO shareholders may be liable for a fraudulent conveyance to such shareholders, double recovery is not allowed.

Section 550(a) of the Bankruptcy Code allows the trustee to recover from any "entity for whose benefit [an avoided] transfer was made." This ability to recover does not encompass *all* entities that benefited from a fraudulent transfer.ⁿ⁸⁵ Instead, the party against whom the trustee seeks to recover must have been, at least in part, the intended beneficiary of the transfer.ⁿ⁸⁶ Section 550(a), however, does not require that such party "actually *receive* the benefit."ⁿ⁸⁷

[a] Pre-LBO Shareholders.

Shareholders who sell stock back to a company are the most obvious targets of fraudulent conveyance claims for the large cash payments received from the target company. There may be practical difficulties in claiming against a large class of pre-LBO shareholders. Moreover, the Court of Appeals for the Tenth Circuit has suggested that no pre-LBO shareholder may be liable for a fraudulent conveyance if the tender offer was a public offering. In *In re Kaiser Steel Corp.*,ⁿ⁸⁸ the court stated, in *dicta*, that payments to pre-LBO shareholders in a tender offer are exempt, under *section 546(e) of the Bankruptcy Code*, from avoidance as fraudulent conveyances because such payments are "settlement[s] of [securities] transaction[s]."ⁿ⁸⁹ *Kaiser Steel* broadly interprets the word "settlement." This use of the exemption provided in section 546(e), which was intended to prevent disruption of the securities markets' clearing mechanisms due to the failure of one or more clearinghouses, has been disavowed in several cases. For example, the court in *Wieboldt Stores, Inc. v. Schottenstein*, ("*Wieboldt II*"),ⁿ⁹⁰ held that a company's transfer of money to shareholders for their stock does not fall within the section 546(e) "settlement" exception.ⁿ⁹¹ In *Wieboldt*, the court distinguished between "innocent" public shareholders and "insider" shareholders in analyzing which shareholders could be liable for a fraudulent

conveyance.ⁿ⁹² The *Wieboldt* court concluded that the liability of the controlling shareholders and insider shareholders, as with that of the LBO lenders, would be assessed by collapsing the LBO transfers into one transaction.ⁿ⁹³ The court collapsed the transactions with respect to those shareholders who allegedly had participated in the LBO negotiations and attempted to structure the LBO "with the requisite knowledge and contemplation that the full transaction, tender offer and LBO, be completed."ⁿ⁹⁴ The court also found that the Board and the insider shareholders knew that *Wieboldt Stores, Inc.*, the acquisition vehicle, intended to finance its acquisition through an LBO.ⁿ⁹⁵ The court also found that the insider shareholders knew that the debtor was insolvent before the LBO and that the LBO would further encumber the debtor's assets.ⁿ⁹⁶ The outcome in *Wieboldt II* stretches the statute's meaning insofar as it divines a distinction between public shareholders and insider shareholders. *Weibolt II* uses a narrower definition of the word "settlement," which, however, appears more in keeping with the statute's purpose than the outcome of *Kaiser*.ⁿ⁹⁷ In *Lowenschuss v. Resorts Int'l, Inc. (In re Resorts Int'l, Inc.)*,ⁿ⁹⁸ the Third Circuit adopted the reasoning in *Kaiser Steel Corp.* and held that a payment of shares during an LBO is a settlement payment and therefore exempted from avoidance as a fraudulent conveyance under section 546(e).ⁿ⁹⁹ Although the court recognized the criticism that followed the Tenth Circuit's *Kaiser Steel Corp.* decision and the fact that such payments "are not the most common securities transaction," the court found that the plain language of section 546 dictated such a result.ⁿ¹⁰⁰

[b] LBO Lenders.

Financiers of an LBO ("LBO Lenders") are another category of transferees against which fraudulent conveyance claims have been asserted. LBO lenders may receive security interests and obligations from the target but the proceeds from such financings pass through to pre-LBO shareholders and give no value to the target. If the target is or becomes insolvent at the time of the LBO, security interests received by LBO lenders may be avoided and claims of the LBO lenders may be subordinated to claims of the target's pre-LBO creditors.ⁿ¹⁰¹

[c] LBO Sponsors.

Some commentators have suggested that LBO sponsors may be liable for transfers to pre-LBO shareholders because the sponsors receive control of the target at little or no cost.ⁿ¹⁰²

In *In re Revco D.S., Inc.* ⁿ¹⁰³ New York Life was an active investor in the group which acquired Old Revco in an LBO.ⁿ¹⁰⁴ The *Revco* court stated that:

[t]he transfers made by Old Revco, the subject of any potential LBO claims, were clearly made for the benefit of New York Life ... [Therefore] New York Life itself, as an entity for whose benefit such transfers were made, would be liable for the value of the property transferred under § 550(a) of the *Bankruptcy Code*.ⁿ¹⁰⁵

The LBO Group, which includes the LBO sponsors, fits within the parameters of "the entity for whose benefit such transfer was made." Just as with the management group leading the LBO in *Revco* if any LBO group motivates and gives effect to the LBO transfer they may be liable under section 550(a).ⁿ¹⁰⁶

[d] Post-LBO Shareholders.

It is possible that a court would find that "the entities for whose benefit" a fraudulent transfer was made were the shareholders of the acquisition vehicle and not the acquisition vehicle itself. *Ohio Corrugating* indicated that this was an acceptable approach where the acquiring shareholder "acted other than in the normal course of business of [the acquisition vehicle or the target company] and [where the plaintiff] submit[s] appropriate evidence as to [the acquiring shareholder's] individual liability."ⁿ¹⁰⁷

[7] Remedies in a Fraudulent Conveyance Action.

When a transfer is determined to be a fraudulent conveyance, the remedy is generally the avoidance of the transfer or obligation and recovery from the transferee of any property transferred or its value.ⁿ¹⁰⁸ Recoupment of the money paid to pre-LBO shareholders for the target company's shares would be the remedy in a fraudulent conveyance action against the pre-LBO shareholders. A novel application of the doctrine of equitable subordination can be found in *In re O'Day Corp.*,ⁿ¹⁰⁹ where the court used the doctrine to fashion a remedy against a lender in a fraudulent conveyance action. This approach was adopted by the *Revco* examiner, as well.

In suggesting a remedy in an LBO fraudulent conveyance action, the *Revco* examiner stated: "rather than unwinding the entire *Revco* LBO, the appropriate remedy is to relieve *Revco* of the obligations it inherited by operation of the Merger ...".ⁿ¹¹⁰ The examiner added that the appropriate remedy for this fraudulent conveyance would place the parties in the position they would have been in had the fraudulent conveyance not occurred. Unwinding the transaction would have resulted in the non-LBO creditors becoming the sole beneficiaries of the remedy fashioned by the examiner. This remedy did not cancel the lender's debt; it merely subordinated the lender's claims to that of claimants holding claims of non-LBO debt.

The *Revco* examiner recommended that the parties agree to a consensual plan of reorganization rather than engaging in expensive and time consuming fraudulent conveyance litigation. The examiner envisioned that the consensual plan of reorganization would take "into account the potential liabilities of all possible defendants of fraudulent conveyance ... actions and consequent benefits to various groups."ⁿ¹¹¹

FOOTNOTES:

(n1)Footnote 1. The 2005 Act extended the look-back period for fraudulent transfers under Section 548(a) to two years. *See 11 U.S.C. § 548(a)(1)*, as amended by Pub. L. No. 109-8 (2005) (enacted on April 20, 2005, and, with respect to the two-year look back period, effective in cases filed more than one year after the date of enactment). Pursuant to the 2005 Act, certain transfers made to or for the benefit of an insider will also be vulnerable to attack, including certain payments made pursuant to an employment contract outside the ordinary course of business. *See 11 U.S.C. § 548(a)(1)(B)(ii)(IV)*, added by the 2005 Act.

In 1998, the "Religious Liberty and Charitable Donation Protection Act of 1998" (Pub. L. No. 105-183) was passed, effective in all cases pending or commenced as the date of enactment, June 19, 1998, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(o)(ii) (Matthew Bender 15th Ed. Revised). *Sections 548, 707 and 1325 of the Bankruptcy Code* were amended. These amendments affect the ability of a bankruptcy trustee to avoid fraudulent transfers and obligations because a transfer of a charitable contribution to a qualified religious or charitable institution will not always be considered a fraudulent transfer. The amendments further prohibit the trustee from avoiding these charitable contributions when acting as lien creditor and successor to certain creditors and purchasers.

(n2)Footnote 2. A debtor in possession in a chapter 11 case has the same rights of avoidance as a trustee. *11 U.S.C. § 1107*. With court authorization, creditors may bring a fraudulent conveyance action in bankruptcy if the trustee or debtor in possession declines. *See In re Evergreen Valley Resort, Inc.*, 27 B.R. 75, 76 (*Bankr. D. Me.* 1983) (finding that a creditors' committee may, with court approval, bring fraudulent conveyance claims if the trustee declines to do so).

(n3)Footnote 3. *See P 1.08[3][c] supra* for discussion of section 548.

(n4)Footnote 4. *See 11 U.S.C. § 548(e)*, added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005) (enacted on April 20, 2005, and effective in cases filed after the date of enactment).

(n5)Footnote 5. *See, e.g.*, H.R. Rep. No. 109-31, pt. 1, to accompany S. 256, 109th Cong., 1st Sess., at 154 (April 8, 2005) ; 151 Cong. Rec. S. 1979 (March 11, 2005).

(n6)Footnote 6. *11 U.S.C. § 544(b)(1)*. This paragraph shall not apply to a transfers of a charitable contribution. *11 U.S.C. § 544(b)(2)*. In 1998, the "Religious Liberty and Charitable Donation Protection Act of 1998" (Pub. L. No.

105-183) was passed, effective in all cases pending or commenced as the date of enactment, June 19, 1998, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(o)(ii) (Matthew Bender 15th Ed. Revised). *Section 544 of the Bankruptcy Code* was also amended. These amendments affect the ability of a bankruptcy trustee to avoid fraudulent transfers and obligations because a transfer of a charitable contribution to a qualified religious or charitable institution will not always be considered a fraudulent transfer. The amendments further prohibit the trustee from avoiding these charitable contributions when acting as lien creditor and successor to certain creditors and purchasers.

(n7)Footnote 7. Currently, eight U.S. jurisdictions have adopted a version of the UFGA: Maryland, New York, and the Virgin Islands. Forty-four U.S. jurisdictions have adopted a version of the UFTA: Alabama, Arizona, Arkansas, California, Colorado, Connecticut, Delaware, District of Columbia, Florida, Georgia, Hawaii, Idaho, Illinois, Indiana, Iowa, Kansas, Maine, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Montana, Nebraska, Nevada, New Hampshire, New Jersey, New Mexico, North Carolina, North Dakota, Ohio, Oklahoma, Oregon, Pennsylvania, Rhode Island, South Dakota, Tennessee, Texas, Utah, Vermont, Washington, West Virginia, Wisconsin and Wyoming, 7A U.L.A. 155, 209 (Supp. 1996).

(n8)Footnote 8. UFGA § 7; *see generally*, H. Chaitman, *The Law of Lender Liability*, P 8.02[2] (EGL 1990) ["Chaitman"]; Emily L. Sherwin, *Creditors' Rights Against Participants in a Leveraged Buyout*, 72 Minn. L. Rev. 449, 466-67 (1988).

(n9)Footnote 9. *See P 1.08[3][c] supra* for a more extensive discussion of "badges of fraud."

(n10)Footnote 10. *See* UFGA §§ 4-6:

§ 4. Conveyances by Insolvent

Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation is incurred without a fair consideration.

§ 5. Conveyance by Persons in Business

Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent.

§ 6. Conveyances by Person About to Incur Debts

Every conveyance made and every obligation incurred without fair consideration when the person making the conveyance or entering into the obligation intends or believes that he will incur debts beyond his ability to pay as they mature, is fraudulent as to both present and future creditors.

(n11)Footnote 11. *See* UFTA § 4. Specifically, § 4 provides that a transfer is fraudulent if:

- (1) with actual intent to hinder, delay, or defraud any creditor of the debtor; or
- (2) without receiving a reasonably equivalent value in exchange for the transfer or obligation and the debtor:
 - (i) was engaged or was about to engage in a business or a transaction for which the remaining assets of the debtor were unreasonably small in relation to the business or transaction; or

(ii) intended to incur, or believed or reasonably should have believed that he [or she] would incur, debts beyond his [or her] ability to pay as they became due.

(n12)Footnote 12. 11 U.S.C. § 544, as amended by the Religious Liberty and Charitable Donation Protection Act of 1998, states:

(a) The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by--

(1) a creditor that extends credit to the debtor at the time of the commencement of the case, and that obtains, at such time and with respect to such credit, a judicial lien on all property on which a creditor on a simple contract could have obtained such a judicial lien, whether or not such a creditor exists;

(2) a creditor that extends credit to the debtor at the time of the commencement of the case, and obtains, at such time and with respect to such credit, an execution against the debtor that is returned unsatisfied at such time, whether or not such a creditor exists; or

(3) a bona fide purchaser of real property other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of the commencement of the case, whether or not such a purchaser exists.

(b)(1) Except as provided in paragraph (2), the trustee may avoid any transfer of an interest of the debtor in property or any obligation incurred by the debtor that is voidable under applicable law by a creditor holding an unsecured claim that is allowable under section 502 of this title or that is not allowable only under section 502(e) of this title.

(2) Paragraph (1) shall not apply to a transfer of a charitable contribution (as that term is defined in section 548(d)(3)) that is not covered under section 548(a)(1)(B), by reason of section 548(a)(2). Any claim by any person to recover a transferred contribution described in the preceding sentence under Federal or State law in a Federal or State court shall be preempted by the commencement of the case

(n13)Footnote 13. See *P 1.08[3][a] supra* for a discussion of section 544.

(n14)Footnote 14. Kennedy, *The Uniform Fraudulent Transfer Act*, 18 U.C.C.L.J. 195, 203 (1986).

(n15)Footnote 15. *E.g.*, *Wieboldt Stores, Inc. v. Schottenstein*, 20 C.B.C.2d 776, 797, 94 B.R. 488, 505 n.25 (N.D. Ill. 1988) ; *United States v. Tabor Court Realty Corp.*, 803 F.2d 1288 (3d Cir. 1986) , *cert. denied*, 483 U.S. 1005, 107 S. Ct. 3229, 97 L. Ed. 2d 735 (1987) ; *In re Vadnais Lumber Supply, Inc.*, 21 C.B.C.2d 19, 27-28, 100 B.R. 127, 134-35 (Bankr. D. Mass. 1989) ; *In re Ohio Corrugating Co.*, 16 C.B.C.2d 821, 826, 70 B.R. 920, 927 (Bankr. N.D. Ohio 1987) . Additional impetus for the application of fraudulent conveyance laws to LBOs came from the examiner's report in *In re Revco D.S., Inc.*, 24 C.B.C.2d 91, 118 B.R. 468 (Bankr. N.D. Ohio 1990) . The bankruptcy court had appointed the Revco examiner to investigate the causes of action and the remedies flowing from Revco's 1986 LBO. The examiner in *Revco* explicitly concluded that "given the current status of the relevant case law and existing statutes, the Examiner cannot conclude that fraudulent conveyance law does not apply to leveraged buyouts." *Id.* The examiner concluded that the majority of courts have determined that statutory constructive fraud provisions are applicable to LBOs. *Id.*

(n16)Footnote 16. [Reserved]

(n17)Footnote 17. *In re O'Day Corp.*, 126 B.R. 370, 394 (Bankr. D. Mass. 1991) ("when a target company assumes liabilities or transfers security interests in its property and the consideration (or loan proceeds) is immediately passed to target's shareholders or third parties then the absence of fair consideration may be equally evident"); *In re Ohio Corrugating Co.*, 16 C.B.C.2d 821, 829, 70 B.R. 920, 927 (Bankr. N.D. Ohio 1987) ("An analysis of an allegedly fraudulent transfer must be directed at what the Debtor surrendered and what the Debtor received, irrespective of what any third party may have gained or lost."); see also *Wieboldt Stores, Inc. v. Schottenstein*, 20 C.B.C.2d 776, 797, 94 B.R. 488, 505 n.25 (N.D. Ill. 1988) ; *In re Vadnais Lumber Supply, Inc.*, 21 C.B.C.2d 19, 29, 100 B.R. 127, 136 (Bankr. D. Mass. 1989) . See *In re Roco Corp.*, 701 F.2d 978, 982, 8 C.B.C.2d 457, 462 (1st Cir. 1983) ; *In re Ipswich Bituminous Concrete Prods., Inc.*, 79 B.R. 511, 517 (Bankr. D. Mass. 1987) .

(n18)Footnote 18. 803 F.2d 1288 (3d Cir. 1986) , cert. denied, 483 U.S. 1005, 107 S. Ct. 3229, 97 L. Ed. 2d 735 (1987) , aff'g in part and vacating in part three district court opinions *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D. Pa. 1983), 571 F. Supp. 935 (M.D. Pa. 1983), 584 F. Supp. 671 (M.D. Pa. 1984) .

(n19)Footnote 19. *Wieboldt Stores, Inc. v. Schottenstein*, 20 C.B.C.2d 776, 794, 94 B.R. 488, 502-503 (N.D. Ill. 1988) . Prior to the buyout the debtor was in a troubled financial position and was unable to service its debts. Within a year of the buyout, the debtor filed under chapter 11. In *Wieboldt*, a holding company, WSI, was created and obtained financing from a lender. The financing enabled the holding company to purchase 99% of the stock of the target company, *Wieboldt*, through a tender offer. Ultimately, the target, through an amended note, became responsible for the loan and in return pledged substantially all of its assets to the lender. The court found that the lender knew that the loan proceeds were to be used to finance the tender offer and to pay the target's existing debts. The court stated,

[the lenders] were well aware of each other's loan or credit commitments to WSI and knew that WSI intended to use the proceeds of their financing commitments to purchase *Wieboldt* shares or options and to release certain *Wieboldt* assets from prior encumbrance... . These LBO lenders agreed with WSI and the Board of Directors to structure the LBO so as to avoid fraudulent conveyance liability.

20 C.B.C.2d 776, 794, 94 B.R. 488, 502-03 (N.D. Ill. 1988) .

(n20)Footnote 20. 20 C.B.C.2d at 794, 94 B.R. at 503 .

(n21)Footnote 21. See, e.g., *In re O'Day Corp.*, 126 B.R. 370, 394-95; (Bankr. D. Mass. 1991) *Credit Managers Ass'n of S. Cal. v. Fed. Co.*, 629 F. Supp. 175 (C.D. Cal. 1985) (finding that the target did not receive fair consideration for the debt it incurred in an LBO but finding no fraudulent transfer on other grounds).

(n22)Footnote 22. See *Wieboldt Stores, Inc. v. Schottenstein*, 20 C.B.C.2d 776, 794, 94 B.R. 488, 503 (N.D. Ill. 1988) . See also *In re Revco, D.S., Inc.*, 24 C.B.C.2d 91, 118 B.R. 468, 520 (Bankr. D. Ohio 1990) . The Revco examiner, relying upon *Wieboldt*, collapsed the Revco LBO and found that Revco was a mere conduit in the Revco LBO financing. Focusing upon the substance of the LBO rather than the form, the examiner determined that the banks and old Revco shareholders reaped the benefit of the financing. The examiner stated "[o]nce the Revco LBO is collapsed, the conclusion flows logically that the Banks and the Old Revco shareholders received consideration from Revco for which Revco derived no benefit." 118 B.R. 468, 520 . The examiner determined that the valuation of Revco "must be made from the perspective of the creditors of each transferee." *Id.* When viewed from the perspective of Revco creditors, the examiner found that Revco derived no benefit for the more than \$1.1 billion of debt it incurred. See also 11 U.S.C. § 550.

(n23)Footnote 23. *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992 (S.D.N.Y. 1991) .

(n24)Footnote 24. *Id.* at 998 .

(n25)Footnote 25. *Id.*

(n26)Footnote 26. See n.8 *supra*.

(n27)Footnote 27. 11 U.S.C. § 548; UFTA § 4. *United States v. Tabor Court Realty Corp.* ("Gleneagles"), 803 F.2d 1288 (3d Cir. 1986) , cert. denied, 483 U.S. 1005, 107 S. Ct. 3229, 97 L. Ed. 2d 735 (1987) , *aff'g three district court opinions: United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D. Pa. 1983), 571 F. Supp. 935 (M.D. Pa. 1983), 584 F. Supp. 671 (M.D. Pa. 1984) .

(n28)Footnote 28. *In re Willson Dairy Co.* (Central Trust Co., N.A., v. Burchett), 30 B.R. 67, 70 (Bankr. S.D. Ohio 1983) .

(n29)Footnote 29. *Gleneagles*, 803 F.2d 1288 (3d Cir. 1986) .

(n30)Footnote 30. *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D. Pa. 1983) .

(n31)Footnote 31. Under § 6, a transfer will be avoided if it was made with "actual intent ... to hinder, delay or defraud either present or future creditors." 37 Pa. Cons. Stat. Ann. § 352(l). Pennsylvania has since replaced the UFCA with the UFTA.

(n32)Footnote 32. In *United States v. Gleneagles Inv. Co.*, 565 F. Supp. 556 (M.D. Pa. 1983) , the lender tried to limit its liability by arguing that only 58% of the loan proceeds were distributed to the target's selling shareholders. The remaining 42% were used by the borrower for legitimate corporate purposes. When presented with this argument, the Court of Appeals for the Third Circuit found it without merit, and reiterated that the lender had been found guilty of "an intentionally fraudulent transaction." 803 F.2d 1288, 1300-01 . The court also noted that \$2.2 million of the loan was used to pay a debt that was personally guaranteed by one of the target's shareholders. *Id.*

(n33)Footnote 33. Generally, insolvency is a question of fact. See, e.g., *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1376 (D.N.J. 1984) .

(n34)Footnote 34. The degree of corporate capitalization is also a question of fact. See, e.g., *Wells Fargo Bank v. Desert View Bldg. Supplies, Inc.*, 475 F. Supp. 693, 697 (D. Nev. 1978) , *aff'd*, 633 F.2d 221 (9th Cir. 1980) (finding inadequate capitalization because the amount of cash that target had on hand was "low" or "extremely low" for a business its size; even though the company survived for one year after the loan transaction, it derived little or no benefit from the loan).

(n35)Footnote 35. See P 4.06[4][d] and [e] *infra* for a discussion of the methods by which a court determines insolvency and undercapitalization.

(n36)Footnote 36. 11 U.S.C. § 548(a)(1)(B)(i), as amended in 1998 by the "Religious Liberty and Charitable Donation Protection Act of 1998" (Pub. L. No. 105-183), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(o)(ii) (Matthew Bender 15th Ed. Revised), effective in all cases pending or commenced as the date of enactment, June 19, 1998.

(n37)Footnote 37. Courts have found that the debtor itself must receive the required value; it is irrelevant that a selling shareholder or another third party received value. *In re O'Day Corp.*, 126 B.R. 370, 394 (Bankr. D. Mass. 1991) ("when a target company assumes liabilities or transfers security interests in its property and the consideration (or loan proceeds) is immediately passed to target's shareholders or third parties then the absence of fair consideration may be equally evident"); *In re Ohio Corrugating Co.*, 16 C.B.C.2d 821, 829, 70 B.R. 920, 927 (Bankr. N.D. Ohio 1987) ("An analysis of an allegedly fraudulent transfer must be directed at what the Debtor surrendered and what the Debtor received, irrespective of what any third party may have gained or lost."); see also *Wieboldt Stores, Inc. v. Schottenstein*, 20 C.B.C.2d 776, 797, 94 B.R. 488, 505 n.25 (N.D. Ill. 1988) ; *In re Vadnais Lumber Supply, Inc.*, 21 C.B.C.2d 19, 29, 100 B.R. 127, 136 (Bankr. D. Mass. 1989) . See *In re Roco Corp.*, 701 F.2d 978, 982, 8 C.B.C.2d 457, 462 (1st Cir. 1983) ; *In re Ipswich Bituminous Concrete Prods., Inc.*, 79 B.R. 511, 517 (Bankr. D. Mass. 1987) .

(n38)Footnote 38. *126 B.R. 370 (Bankr. D. Mass. 1991)* .

(n39)Footnote 39. In 1984, Lear Siegler, Inc. ("LSI"), a publicly held company, acquired the O'Day/CAL line of sailboats and the Prindle line of catamarans. Three years later, Forstmann Little & Co. ("Forstmann"), with financing from Meritor, acquired all of the stock of LSI through a leveraged buyout in which LSI was taken private. The LBO utilized a "mirror" subsidiary structure in which O'Day became a separate subsidiary and was allocated a portion of the LBO debt through intercompany notes.

(n40)Footnote 40. *945 F.2d 635, 25 C.B.C.2d 1064 (3d Cir. 1991)* , *cert. denied*, *503 U.S. 937, 112 S. Ct. 1476, 117 L. Ed. 2d 620 (1992)* .

(n41)Footnote 41. *945 F.2d 635, 647, 25 C.B.C.2d 1064,1078* . *Mellon* places the duty to offer evidence with respect to these issues squarely on the plaintiff bringing a fraudulent conveyance claim. The decision specifically states that the plaintiff failed to satisfy its burden of proof of showing that the target failed to receive reasonably equivalent value in the LBO. According to the court, the plaintiff erred in offering no evidence with respect to the relative value to the debtor of increased access to credit, synergies from the LBO and rights to contribution. "The [plaintiff] acted on the blind assumption that they had no value and the bankruptcy court agreed." *945 F.2d 635, 648, 25 C.B.C.2d 1064, 1080* . However difficult to quantify, the plaintiffs were required to offer some testimony, preferably expert, with respect to these items.

(n42)Footnote 42. *945 F.2d 635, 647, 25 C.B.C.2d 1064, 1078* .

(n43)Footnote 43. Another unsuccessful fraudulent conveyance attack involved the LBO and subsequent bankruptcy of Craddock Terry Shoe Corp. ("CT"). *C-T of Virginia, Inc. v. Euroshoe Assoc., Ltd. P'ship*, *762 F. Supp. 675 (W.D. Va. 1991)* , *aff'd without op.*, *953 F.2d 637 (4th Cir. 1992)* . In *CT*, the district court concluded that the target company received some "consideration deemed valuable at law." *953 F.2d 637, 638 (citing Va. Code § 55-81)*.

On November 11, 1985, HH Holdings purchased the common stock of CT in what has become known as "reverse triangular merger." *Id. at 676* . HH Acquisition, a wholly owned subsidiary of HH Holdings, was formed for the purpose of completing the merger. HH Acquisition then merged into CT. *Id.* The end result was that HH Holdings owned the surviving corporation. At the close of the transaction, CT had borrowed \$27 million of the \$31 million needed to purchase 100% of its stock. Shortly after the LBO, CT was unable to pay its bills. On October 21, 1987, CT filed for bankruptcy. *Id. at 676-77* .

The court concluded that CT had provided its former shareholders with cash and had in return received a \$4 million cash "investment of new capital as well as new management from HH Holdings." The court concluded, "although CT may have given up more than it received, it gained something, and that is enough to prevent avoidance of the transaction." *953 F.2d 637, 638* .

(n44)Footnote 44. Under the Bankruptcy Code, the test for determining whether a company is insolvent is, generally, whether the fair value of that company's liabilities exceeds its assets. *11 U.S.C. § 101(32)* (definition of "insolvent"). The UFCA's definition of insolvency provides that "[a] person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and mature." UFCA 2(1). The concept of present fair salable value requires one to look at the value that can be obtained when assets are sold currently in a relevant market. Under this definition, if a debtor has short term debt coupled with hard to sell assets, it may be deemed insolvent, though it might not be under the Bankruptcy Code definition. *See United States v. Gleneagles Inv. Co.*, *565 F. Supp. 556, 580-583 (M.D. Pa. 1983)* . The court calculated insolvency by valuing the debtor's assets on a present salable value as opposed to a fair market value. The borrower's major assets, huge land holdings, were not readily salable. When the court valued the lands on a balance sheet basis it determined that the borrower had been rendered insolvent at the time of closing. Prior to adopting the UFTA, section 352(1) of the Pennsylvania UFCA defined insolvency in the following manner: "A person is insolvent when the present

fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." 39 Pa. Cons. Stat. Ann. § 352(l). The UFTA's balance sheet definition of insolvency more closely mirrors the Bankruptcy Code's definition. Under the UFTA, a debtor is insolvent if the sum of its debts are greater than its assets at a fair valuation. UFTA § 2. In addition, the UFTA contains the rebuttable presumption that a debtor who is not currently paying its debts as they become due is insolvent. UFTA § 2(b).

(n45)Footnote 45. *See, e.g., In re O'Day Corp.*, 126 B.R. 370, 397 (Bankr. D. Mass. 1991) .

(n46)Footnote 46. Three standard methods have been developed to analyze whether a company is solvent under a going concern test: a comparable company analysis, a comparable acquisition analysis and a discounted cash value analysis. *See P 3.05[2] supra* for a discussion of these three valuation techniques.

(n47)Footnote 47. In *Telefest, Inc. v. VU-TV, Inc.*, 591 F. Supp. 1368, 1376 (D.N.J. 1984) , the court held that proving that a company's financial picture liabilities exceed assets does not inevitably determine insolvency, especially "if a corporation is actively pursuing its regular business with a reasonable expectation that business conditions will improve." In some cases courts look to how and when assets can be sold to pay liabilities. In those analyses, taxes and other costs incident to such a sale should be deducted in arriving at the enterprise value. In looking to value what liabilities should be subtracted, contingent liabilities must be valued by giving them a present value and discounting that value by the likelihood the liabilities will become liquidated. For example, in *In re O'Day Corp.*, 126 B.R. 370 (Bankr. D. Mass. 1991) (the court pointed out that with respect to O'Day's balance sheet, solvency turned on the value attributed to O'Day's intangibles. The court concluded that on June 30, 1987, there was insufficient evidence to rebut the trustee's valuation of O'Day's intangibles at zero. The court found the company did not own patents and trademarks; therefore, Meritor's expert could not assign \$6 million of good will to these intangibles. In addition, the court found that O'Day did not obtain the title to real estate valued at \$4 million until months after the LBO. *In re O'Day Corp.*, 126 B.R. at 403-04 .

(n48)Footnote 48. Under a balance sheet test all liabilities are taken into account, including contingent liabilities.

(n49)Footnote 49. In determining insolvency for fraudulent conveyance purposes, the book value of the company's assets is not controlling nor is the value determined by application of generally accepted accounting principles ("GAAP"). *See In re O'Day Corp.*, 126 B.R. at 398 .

(n50)Footnote 50. *See In re O'Day Corp.*, 126 B.R. at 397 ; *In re Ohio Corrugating Co.*, 91 B.R. 430, 438 n.11 (Bankr. N.D. Ohio 1988) (stating that "[i]n spite of their propriety according to GAAP, a court may modify balance sheet entries (i.e., increase/decrease the value of an asset or reduce/elevate the amount of the liability) in order to more accurately reflect the financial condition of the Debtor.").

(n51)Footnote 51. 91 B.R. 430 (Bankr. N.D. Ohio 1988) .

(n52)Footnote 52. *Id.* at 440 .

(n53)Footnote 53. 971 F.2d 1056 (3d Cir. 1992) .

(n54)Footnote 54. *Id.* at 1076 .

(n55)Footnote 55. *Id.* at 1058-59 .

(n56)Footnote 56. 127 B.R. 958 (W.D. Pa. 1991) .

(n57)Footnote 57. 1993 Bankr. LEXIS 2225 (Bankr. N.D. Ill. Dec. 22, 1993), at *7-10 .

(n58)Footnote 58. *Id.*

(n59)Footnote 59. *Id.*

(n60)Footnote 60. *Id.*

(n61)Footnote 61. *Id.*

(n62)Footnote 62. Unreasonably small capitalization has been defined as "not [] so extreme a condition of financial debility as to constitute equitable insolvency, which is an inability to pay debts as they mature [U]nreasonably small capitalization encompasses financial difficulties which are short of equitable insolvency or bankruptcy insolvency but are likely to lead to some type of insolvency eventually." *In re O'Day Corp.*, 126 B.R. 370, 407 (Bankr. D. Mass. 1991) .

(n63)Footnote 63. *In re Vadnais Lumber Supply, Inc.*, 21 C.B.C.2d 19, 31, 100 B.R. 127, 137 (Bankr. D. Mass. 1989) , in which the court found that the leveraged buyout did result in unreasonably small capitalization.

(n64)Footnote 64. The court in *In re O'Day* stated that the critical factor in determining a company's sufficiency of working capital is the reasonableness of its projections. *In re O'Day Corp.*, 126 B.R. 370, 405 (Bankr. D. Mass. 1991) . The *O'Day* court also determined that the reasonableness of the assumptions underlying such projections are significant because both ability to repay debt and ability to successfully operate a business are dependent upon the reasonableness of the projections. *Id.* at 404-05 .

(n65)Footnote 65. *See Credit Managers Ass'n of Southern California v. the Federal Company*, 629 F. Supp. 175, 187 (C.D. Cal. 1985) .

(n66)Footnote 66. These types of questions proved of particular importance in *Credit Managers*, where the debtor was affected by a number of adverse events following its leveraged buyout, including a two month strike, the loss of a large customer due to the shutdown of the customer and a slowdown in the economy. *Credit Managers Ass'n of S. Cal. v. Fed. Co.*, 629 F. Supp. 175, 187 (C.D. Cal. 1985) . *See* discussion at nn. 68-70 *infra*.

(n67)Footnote 67. 629 F. Supp. 175 (C.D. Cal. 1985) .

(n68)Footnote 68. *But see In re Vadnais Lumber Supply, Inc.*, 21 C.B.C.2d 19, 31, 100 B.R. 127, 137 (Bankr. D. Mass. 1989) , in which the court found that an LBO did result in unreasonably small capitalization.

(n69)Footnote 69. These unforeseen business conditions included a strike, the loss of a significant customer and a downturn in the economy; *but see In re O'Day Corp.*, discussed at P 4.06[4][c] *supra*.

(n70)Footnote 70. *See Moody v. Sec. Pac. Bus. Credit, Inc.*, 971 F.2d 1056 (3d Cir. 1992) .

(n71)Footnote 71. 971 F.2d 1056, 1072-73 (quoting *Mellon*, 945 F.2d 635, 647) .

(n72)Footnote 72. *Id.* at 1073 .

(n73)Footnote 73. *Moody v. Sec. Pac. Bus. Credit, Inc.*, 127 B.R. 958, 974, 990 (W.D. Pa. 1991) .

(n74)Footnote 74. *In re Envirodyne Indus., Inc.*, 1993 WL 566565 (Bankr. N.D. Ill. Dec. 20, 1993), at *11 .

(n75)Footnote 75. 1993 WL 566565 (Bankr. N.D. Ill. Dec. 20, 1993 at *16-17.

(n76)Footnote 76. *In re O'Day Corp.*, 126 B.R. 370, 404 (Bankr. D. Mass. 1991) .

(n77)Footnote 77. *Credit Managers Ass'n of S. Cal. v. Fed. Co.*, 629 F. Supp. 175, 187 (C.D. Cal. 1985) .

(n78)Footnote 78. 126 B.R. 370, 405 (Bankr. D. Mass. 1991) .

(n79)Footnote 79. 126 B.R. 370, 406 .

(n80)Footnote 80. 126 B.R. 370, 406 (emphasis added).

(n81)Footnote 81. The court stated:

Although Meritor points to a variety of unpredictable, internal and external problems, such as poor management, bad marketing decisions, decline in the number of dealers and sales people, and the stock market crash of October 1987 as the causes of O'Day's dismal performance following the LBO ... the Court finds that labor problems, cost variances and cyclicalities in the industry were the major contributors to O'Day's fiscal woes and were manifest and readily predictable prior to the LBO. Thus, using the *Credit Managers* test ... the Court concludes that O'Day was left with unreasonably small capital.

126 B.R. 370, 407 .

(n82)Footnote 82. *In re Revco, D.S., Inc.*, Nos. 588-1305, 588-1308 through 588-1321, 588-1761 through 588-1812, and 588-1820, Final Report of Examiner Professor Barry Lewis Zaretsky at 6 (Bankr. N.D. Ohio Dec. 17, 1990) .

(n83)Footnote 83. See *In re Morse Tool, Inc.*, 108 B.R. 384, 388 (Bankr. D. Mass. 1989) (applying the law of Massachusetts because Massachusetts was the situs of the debtor, the debtor's assets and the largest number of the debtor's creditors); see also *In re Kaiser Steel Corp.*, 18 C.B.C.2d 1403, 1410, 87 B.R. 154, 159-60 (Bankr. D. Colo. 1988) (applying California fraudulent conveyance law because all or substantially all of the transactions related to the LBO occurred in or originated from California; the shareholders' meeting approving the LBO occurred in California; substantial cash distributions for the LBO were allegedly made in or directed from California; the debtor's principal place of business was California; and a significant number of creditors affected by the transfers were located in California), cert. denied sub nom. *Kaiser Steel Res., Inc. v. Pearl Brewing Co.*, 505 U.S. 1213, 112 S. Ct. 3015, 120 L. Ed. 2d 887 (1992) .

(n84)Footnote 84. Section 550(a) of the Bankruptcy Code states that, where a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of the Code:

the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from

- (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
- (2) any immediate or mediate transferee of such initial transferee.

11 U.S.C. § 550(a) (emphasis added).

(n85)Footnote 85. There is no legislative history regarding the meaning or scope of the beneficiary language of section 550(a). Cf. *Bonded Fin. Servs., Inc. v. European Am. Bank*, 838 F.2d 890, 893, 18 C.B.C.2d 155, 159 (7th Cir. 1988) .

(n86)Footnote 86. Cf. *In re Colombian Coffee Co.*, 75 B.R. 177 (S.D. Fla. 1987) .

(n87)Footnote 87. *Wieboldt Stores, Inc. v. Schottenstein*, 131 B.R. 655, 666 (N.D. Ill. 1991) ("Wieboldt II") (citing *In re Universal Clearing House Co.*, 62 B.R. 118, 127 (D. Utah 1986)) (emphasis added). But see *In re Ozark Rest. Equip. Co.*, 77 B.R. 686, 695 (W.D. Ark. 1987) ("The trustee cannot recover "against one who has not received any property or benefit from the debtor or his transferee, immediate or mediate." ") (citing 4 Collier on Bankruptcy P

548.07[5], p. 548-86 (15th Ed. 1986)) [now 5 *Collier on Bankruptcy*, P 548.07[1] (Matthew Bender 15th Ed. Revised)], *aff'd in part, rev'd in part*, 850 F.2d 342, 19 C.B.C.2d 35 (8th Cir. 1988) .

(n88)Footnote 88. 952 F.2d 1230, 26 C.B.C.2d 443 (10th Cir. 1991) , *cert. denied sub nom. Kaiser Steel Res., Inc. v. Pearl Brewing Co.*, 505 U.S. 1213, 112 S. Ct. 3015, 120 L. Ed. 2d 887 (1992) .

(n89)Footnote 89. 952 F.2d 1230, 1240 (10th Cir. 1991) .

(n90)Footnote 90. 131 B.R. 655 (N.D. Ill. 1991) .

(n91)Footnote 91. 131 B.R. 655, 663-65 (N.D. Ill. 1991) . *See also Brandt v. Hicks, Muse & Co. (In re Healthco Int'l, Inc.)*, 35 C.B.C.2d 1345, 195 B.R. 971 (Bankr. D. Mass. 1996) (section 546(e) did not apply to per share payments made by chapter 7 debtor-corporation during LBO to selling shareholder).

(n92)Footnote 92. 20 C.B.C.2d 776, 794, 94 B.R. 488, 502-03 (N.D. Ill. 1988) .

(n93)Footnote 93. *Id.*

(n94)Footnote 94. 20 C.B.C.2d 776, 793, 94 B.R. 488, 502 (N.D. Ill. 1988) . The *Wieboldt* court, in a footnote, imputed the board of directors' state of mind to the controlling shareholders who had nominated a majority of the directors. The board of directors once apprized of the fraudulent conveyance law, agreed to structure the LBO to avoid liability, recommended that the debtor accept the tender offer and tendered their own shares to WSI. 94 B.R. 488, 502 n.20, 20 C.B.C.2d 776, 793 n.20 .

(n95)Footnote 95. 20 C.B.C.2d 776, 793, 94 B.R. 488, 502 (N.D. Ill. 1988) .

(n96)Footnote 96. *Id.*

(n97)Footnote 97. *See also* The Revco Examiner's Report at 232-37 (discussing and criticizing *Kaiser Steel Corp. v. Charles Schwab & Co.*, 913 F.2d 846, 23 C.B.C.2d 1403 (10th Cir. 1990)) .

(n98)Footnote 98. 181 F.3d 505 (3d Cir. 1999) .

(n99)Footnote 99. *Id.* at 516 .

(n100)Footnote 100. *Id.*

(n101)Footnote 101. *See, e.g., Mellon Bank, N.A. v. Metro Communications, Inc.*, 945 F.2d 635, 25 C.B.C.2d 1064 (3d Cir. 1991) , *cert. denied*, 503 U.S. 937, 112 S. Ct. 1476, 117 L. Ed. 2d 620 (1992) ; *Credit Managers Asso. v. Federal Co.*, 629 F. Supp. 175 (C.D. Cal. 1985) .

(n102)Footnote 102. *See In re Revco D.S., Inc.*, Nos. 588-1305, 588-1308-1321, 588-1761-1812, 588-1820, Final Report of Examiner at 237 (Bankr. N.D. Ohio dated Dec. 17, 1990) (hereinafter "Revco Examiner's Report") ("to the extent that [the acquisition vehicle] benefitted from transfers made on its behalf, [it] may be liable to Revco"). *See also In re Ohio Corrugating Co.*, 91 B.R. 430, 430 (Bankr. N.D. Ohio 1988) (acquisition vehicle and shareholder sued on fraudulent conveyance claim); King, *Fraudulent Conveyance Law: Taking the Fun Out of LBO's* at 46-47 (theorizing that even where an "LBO Group did not receive directly any of the Target's property, [because the Target's conveyances were] effected, at least in part, for the benefit of the LBO Group and its participants ... if the payments to the Selling Shareholders constitute a Bankruptcy Code fraudulent conveyance, the LBO Group might *in some limited circumstances* be liable for an amount up to the price paid to the Selling Shareholders") (emphasis added).

(n103)Footnote 103. 24 C.B.C.2d 91, 118 B.R. 468 (Bankr. N.D. Ohio 1990) .

(n104)Footnote 104. New York Life invested \$75 million in the stock purchase and received \$1.8 million in commitment fees in connection with a stock purchase and \$30 million as payment on a preexisting debt.

(n105)Footnote 105. 24 C.B.C.2d 91, 101, 118 B.R. 468, 475 (Bankr. N.D. Ohio 1990) .

(n106)Footnote 106. Cf. 5 Collier on Bankruptcy, P 550.02 (Matthew Bender 15th Ed. Revised). It is also consistent with the bankruptcy court's statement in *Ohio Corrugating* that although fraudulent conveyance law may be applied to an acquiring shareholder, the LBO acquisition vehicle may be the more appropriate defendant where "there is no evidence that [the acquiring shareholder] ever intended to defraud the Debtor's creditors." *In re Ohio Corrugating Co.*, 91 B.R. 430, 439 (Bankr. N.D. Ohio 1988) .

(n107)Footnote 107. *In re Ohio Corrugating Co.*, 16 C.B.C.2d 821, 826, 70 B.R. 920, 925 (Bankr. N.D. Ohio 1987) . There are few cases dealing with this point. In non-LBO contexts, some courts have analyzed whether to impose "beneficiary or transferee" liability on shareholders under a traditional "piercing the corporate veil" inquiry. For example, in *In re Ozark Rest. Equip. Co.*, 77 B.R. 686, 696 (W.D. Ark. 1987) , *aff'd in part, rev'd in part*, 850 F.2d 342, 19 C.B.C.2d 35 (8th Cir. 1988) , because the "transferee entities were used as mere instrumentalities by the defendants," the court found it proper to "set aside the corporate formalities and hold [the defendants] individually liable" under section 550(a).

(n108)Footnote 108. See *Crowthers McCall Pattern Inc. v. Lewis*, 129 B.R. 992, 996-98 (S.D.N.Y. 1991) ; *In re Revco D.S., Inc.*, 118 B.R. 468, 517 (Bankr. N.D. Ohio 1990) (Examiner's Preliminary Report); see also *Feltinton v. Rudnik*, 401 Ill. 362, 363, 82 N.E.2d 436, 437 (1948) ("A [fraudulent] conveyance ... is void only as against creditors, and then only to the extent to which it may be necessary to deal with the conveyed estate for their satisfaction.").

(n109)Footnote 109. 126 B.R. 370, 412-413 (Bankr. D. Mass. 1991) .

(n110)Footnote 110. 24 C.B.C.2d 91, 118 B.R. 468, 523 (Bankr. N.D. Ohio 1990) .

(n111)Footnote 111. *In re Revco D.S., Inc.*, Nos. 588-1305, 588-1308 through 588-1321, 588-1761 through 588-1812, and 588-1820, Final Report of Examiner Professor Barry Lewis Zaretsky at 6 (Bankr. N.D. Ohio December 17, 1990) .



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CHAPTER 4 Representing the Lender

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P 4.06A Other Theories of Liability for LBO Lenders.

In later LBO cases, there emerged, in addition to the fraudulent conveyance analysis, a new theory of lender liability. Financiers of highly leveraged transactions have been targeted for liability under a theory that they aided and abetted corporate managers in the breach of their fiduciary duties.

Under state corporate law, officers and directors owe fiduciary duties to their corporation and its shareholders, for breach of which they may be held civilly liable.ⁿ¹ These duties include a duty of care, which obliges a director to exercise the care that an ordinarily prudent person would exercise in the same or similar circumstances, and a duty of loyalty, which prohibits faithless or self-dealing behavior.

The business judgment rule, however, means that directors are presumed to make business decisions on an informed basis, in good faith and in the honest belief that the action taken is in the best interests of the corporation.ⁿ² The protection of this rule is not available, however, to a director who acts with the sole or primary purpose of entrenching himself or herself, or otherwise engages in self-dealing.ⁿ³ In such circumstances, a director's conduct will be subject to the more onerous "entire fairness" test, in order to meet the terms of which the director must establish that the transaction was entirely fair to the corporation.ⁿ⁴

It has been held that one who knowingly joins with a fiduciary in the breach of a fiduciary duty is equally culpable with the fiduciary,ⁿ⁵ and courts have indicated a willingness to apply this rule of law to participants in the financing of highly leveraged transactions. The elements of a claim for aiding and abetting a breach of fiduciary duty are (i) the existence of a fiduciary relationship, (ii) a breach of the fiduciary's duty, and (iii) knowing participation in that breach by a defendant that is not a fiduciary.ⁿ⁶ The following three cases illustrate the emergence of this theory.

In *Crowthers McCall Pattern, Inc. v. Lewis*,ⁿ⁷ creditors of Crowthers Pattern brought an action on behalf of the company challenging an LBO. In addition to pleading a fraudulent conveyance cause of action against the LBO lenders,ⁿ⁸ the creditors claimed that the lenders aided and abetted the directors in a breach of fiduciary duty. Specifically, the creditors alleged that the lenders knew that the directors' approval of the LBO was a breach of fiduciary responsibilities and aided and abetted that breach by providing bridge financing for the transaction. The district court denied the lenders' motion to dismiss this count of the complaint, finding the allegations sufficient to state a claim for aiding and abetting a breach of fiduciary duty under New York law.ⁿ⁹

A bankruptcy court in Illinois reached a similar result in *In re Aluminum Mills Corp.*ⁿ¹⁰ Aluminum Mills failed not long after a \$34 million management-led LBO. As in *Crowthers*, unhappy creditors then launched an attack on the LBO on behalf of the corporation, claiming the buyout constituted a fraudulent conveyance and a breach of fiduciary duty by the directors. The complaint further alleged that Citicorp, one of the lenders that provided financing for the LBO, "knowingly and intentionally induced" a breach by the directors.

Unlike in *Crowthers*, however, the aiding and abetting claim against the lender in *Aluminum Mills* did not hinge on an alleged fiduciary breach by the directors in authorizing the LBO, but on a more unusual factual basis. Citicorp had obtained a general liability release a few days before Aluminum Mill's bankruptcy filing by paying \$100,000 to a consulting firm controlled by one of the directors. According to the creditors' complaint, the directors' decision to release Citicorp from liability without adequate consideration to the debtor amounted to a breach of fiduciary responsibilities. Citicorp was alleged to have knowingly and intentionally induced this breach.

The court found these allegations sufficient to state a claim for inducement of breach of fiduciary duty and denied Citicorp's motion to dismiss this claim. The court's decision is significant in two respects: first in its adoption of the emerging theory of aiding and abetting liability for lenders, and second in demonstrating that any fiduciary breach in the context of the transaction, not just the directors' authorization of the LBO, may provide the basis for lender liability if the lender can be shown to be linked to the wrongful conduct in some way.

In re Interco, Inc.,ⁿ¹¹ an outgrowth of a failed recapitalization, provides another example of a potential claim against lenders for aiding and abetting management in breaching their fiduciary duties. In *Interco*, the directors voted to incur a substantial amount of bank debt in order to finance sizeable dividends of cash and securities. The dividends were part of an ultimately successful effort to thwart a hostile tender offer.

The examiner found that the directors, many of whom had a personal stake in fending off the tender offer, had breached their fiduciary duty by responding in a "coercive" manner to a "noncoercive" tender offer. In addition, the examiner found that certain officers and directors had also breached their fiduciary duty by failing to apprise the board and company advisors adequately about pertinent information.ⁿ¹² Noting the precedents of *Crowthers* and *Aluminum Mills*, the examiner concluded that an action for aiding and abetting Interco's management in its breach would also lie against the banks. The banks had stood to derive substantial fees from the recapitalization and were fully apprised of the attendant risks and the "slim cushion that lay between the success and failure of the Recapitalization."ⁿ¹³

FOOTNOTES:

(n1)Footnote 1. *E.g., Polk v. Good*, 507 A.2d 531, 536 (Del. 1986) (citing *Guth v. Loft, Inc.*, 5 A.2d 503, 510 (Del. 1939)) . *See also Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) ; *In re Interco*, No. 91-4-00442-172, Report of the Examiner at 390 (Bankr. E.D. Mo. Oct. 23, 1991); *see generally* ch. 3 *supra* for a discussion of the duty of loyalty.

(n2)Footnote 2. *E.g., Aronson v. Lewis*, 473 A.2d 805, 812 (Del. 1984) , *overruled in part by Brehm v. Eisner*, 746 A.2d 244, 2000 Del. LEXIS 51 (Del. 2000) .

(n3)Footnote 3. *See, e.g., Interco*, n.1 *supra* , Report of the Examiner at 391-92, citing *Weinberger v. UOP, Inc.*, 457 A.2d 701, 710 (Del. 1983) .

(n4)Footnote 4. *E.g., Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1280 (Del. 1989) ; *Interco*, n.1 *supra* , Report of the Examiner at 392.

(n5)Footnote 5. *See, e.g., Mills Acquisition Co. v. MacMillan, Inc.*, 559 A.2d 1261, 1284 n.33 (Del. 1989) .

(n6)Footnote 6. *Weinberger v. Rio Grande Indus., Inc.*, 519 A.2d 116, 131 (Del. Ch. 1986) .

(n7)Footnote 7. 129 B.R. 992 (S.D.N.Y. 1991) .

(n8)Footnote 8. See P 4.06[4][d] *supra*, for a discussion of the fraudulent conveyance claim made in *Crowthers*.

(n9)Footnote 9. *Crowthers McCall Pattern, Inc. v. Lewis*, 129 B.R. 992, 999 (citing *Resnick v. Resnick*, 722 F. Supp. 27 (S.D.N.Y. 1989) ; *Feinberg Testamentary Trust v. Carter*, 652 F. Supp. 1066 (S.D.N.Y.) , *reh'g denied*, 664 F. Supp. 140 (S.D.N.Y. 1987) ; *Seigal v. Merrick*, 422 F. Supp. 1213 (S.D.N.Y. 1976) .

(n10)Footnote 10. 25 C.B.C.2d 1120, 132 B.R. 869 (Bankr. N.D. Ill. 1991) .

(n11)Footnote 11. No. 91-44-00442-172 (Bankr. E.D. Mo. Oct. 23, 1991).

(n12)Footnote 12. *Id.*, Report of the Examiner at 431-32.

(n13)Footnote 13. *Id.*, Report of the Examiner at 493-94. The examiner did note, however, that certain managers and directors had been less than forthright with the banks with respect to presenting accurate projections and proposing realistic cost-saving formulae. The examiner, in light of practical considerations, stopped short of recommending that an action be brought against the banks.



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P 4.07 Equitable Subordination.

[1] Generally.

Although equitable subordination is a remedy available only in a bankruptcy case, a lender confronted with a workout must keep this doctrine in mind and determine any possible vulnerability when considering its willingness to compromise in an out of court restructuring. If a lender's claim is equitably subordinated, the lender's priority in the distribution of the assets of the estate will change.ⁿ¹ The lender's claim will be subordinated to all other debt of the debtor.

[2] Pre-Code Case Law.

The leading pre-Bankruptcy Code equitable subordination case is *Pepper v. Litton*.ⁿ² In that case, the controlling shareholder of the debtor, used his insider position to engage in manipulative transactions with the debtor in order to avoid payment of a debt owed by the corporation to Pepper, a creditor. The debtor filed a voluntary petition under the Bankruptcy Act, leaving Litton with salary claims superior to Pepper's claims and insufficient funds to satisfy the latter's claims. The Supreme Court held that the bankruptcy court possessed the power to equitably subordinate an insider's claim and subordinated Litton's claim to Pepper's claim. The court stated that a bankruptcy court may "sift the circumstances surrounding any claim to see that injustice or unfairness is not done in administration of the bankrupt estate."ⁿ³

[3] Under the Bankruptcy Code.

*Section 510(c) of Bankruptcy Code*ⁿ⁴ adopts the pre-Code judicial doctrine of equitable subordination under which the courts, in the interest of fairness, can subordinate the claim of any creditor to the claim of any other creditor. However, the danger of equitable subordination for lenders has been greatly exaggerated.

The issue of equitable subordination arises typicallyⁿ⁵ when creditors exercise improper control over the debtor,ⁿ⁶ either by abusing management change clauses of contractual provisions or by exerting economic pressure. The more extensive the control and the more extensively this control is exercised to the detriment of the other creditors, the greater the likelihood that the court will subordinate the claim.ⁿ⁷

Three conditions must exist to equitably subordinate a claim. First, the claimant must have engaged in inequitable

conduct;ⁿ⁸ second, the inequitable conduct must have resulted in injury to the other creditors of the debtor or must have resulted in the claimant gaining an unfair advantage; and third, the claim must not be inconsistent with other provisions of the Bankruptcy Code.ⁿ⁹ The court will subordinate the claim only to the extent of actual injury to another creditor or group of creditors.

In a chapter 11 case, a proof of claim is *prima facie* evidence that the claim is valid. If the trustee wants the court to subordinate a claim, it must produce evidence of impropriety "sufficient" to defeat this *prima facie* evidence of validity. Once evidence of domination and control is established, the burden shifts back to the claimant to prove the conduct was fair.

The sufficiency of evidence needed to subordinate a claim depends upon whether the claimant is an insider or an outsider. A very high level of control must be shown before a lender will be considered an insider of its borrower.ⁿ¹⁰ However, once the claimant has been deemed an insider, the trustee need only bring material evidence of inequitable conduct.ⁿ¹¹ If the claimant is not an insider, the trustee must prove egregious or gross conduct, established on a case-by-case basis.ⁿ¹²

FOOTNOTES:

(n1)Footnote 1. The following commentary is particularly helpful: Andrew DeNatale & Prudence B. Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 *Bus. Law.* 417 (1985).

(n2)Footnote 2. 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939) .

(n3)Footnote 3. 308 U.S. 295, 308, 60 S. Ct. 238, 246, 84 L. Ed. 281, 290 .

(n4)Footnote 4. 11 U.S.C. § 510(c) states:

(c) Notwithstanding subsections (a) and (b) of this section, after notice and a hearing, the court may-

(1) under principles of equitable subordination, subordinate for purposes of distribution all or part of an allowed claim to all or part of another allowed claim or all or part of an allowed interest to all or part of another allowed interest; or

(2) order that any lien securing such a subordinated claim be transferred to the estate.

(n5)Footnote 5. A novel application of the doctrine of equitable subordination can be found in *In re O'Day Corp.*, 126 B.R. 370, 412-413, (Bankr. D. Mass. 1991) , in which the court utilized the doctrine to create a remedy against the lender in a fraudulent conveyance case. As noted at P 4.06[7], *supra* , this approach was adopted by the Revco examiner.

(n6)Footnote 6. *New Commonwealth Publ'g Co. v. Baybank Middlesex (In re New Commonwealth Publ'g Co.)*, 23 C.B.C.2d 1419, 118 B.R. 155 (Bankr. D. Mass. 1990) .

(n7)Footnote 7. Some courts have refused to subordinate a lender's claims when they have determined that the lender exerted legitimate controls over the borrower as reflected in the lender's loan agreement. In *In re Clark Pipe & Supply Co.*, 893 F.2d 693, 22 C.B.C.2d 500 (5th Cir. 1990) , the Court of Appeals for the Fifth Circuit, in reversing the bankruptcy court, noted that lenders always exercise some control over their borrowers. The court determined that the lender had merely exercised its legal right under its loan agreement to reduce funding as the debtor's business slowed. There was no evidence of anything other than an arm's-length bargaining process. The loan documents were not atypical and the lender did not exceed its authority under its loan agreement.

In *In re W.T. Grant Co.*, 699 F.2d 599 (2d Cir.) , *cert. denied sub nom. Cosoff v. Rodman*, 464 U.S. 822, 104 S. Ct. 89,

78 L. Ed. 2d 97 (1983) , in upholding a settlement adopted by the bankruptcy court, the Court of Appeals for the Second Circuit refused to subordinate the banks' claims, holding that the banks had not engaged in fraudulent conduct. Writing for the court, Judge Henry Friendly observed that it was insufficient to sustain the claims of the subordinated debenture holders bringing the appeal merely to show that the banks proffered unpalatable advice to the debtor, even if such advice had been coupled with an implicit threat that, unless taken, additional loans would not be forthcoming. Nor did the court object to the banks' objection to debtor's use of the proceeds of accounts receivables to pay the subordinated debenture holders.

(n8)Footnote 8. *But see In re Virtual Network Servs. Corp.*, 902 F.2d 1246, 1250, 22 C.B.C.2d 1667, 1672 (7th Cir. 1990) ("It is clear that in principle, equitable subordination no longer requires, in all circumstances, some inequitable conduct on the part of the creditor.") The Seventh Circuit agreed with the district court that the "goal of equitable subordination focuses not on the conduct of the creditor but on the fairness to creditors in a particular case." *Id. Accord In re CF & I Fabricators*, 53 F.3d 1155 (10th Cir. 1995) , *vacated sub nom, United States v. Reorganized CF & I Fabricators*, 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463 (1996) ; *Texas Am. Oil Corp. v. U.S. Dep't of Energy*, 44 F.3d 1557 (Fed. Cir. 1995) . Although the Supreme Court, as yet, has not ruled on whether inequitable conduct is always a prerequisite to equitable subordination, the Court has placed limits on the power of a bankruptcy court to equitably subordinate claims in the absence of creditor misconduct. *See United States v. Noland*, 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748, 35 C.B.C.2d 1 (1996) . In *Noland*, the Court held that a bankruptcy court may not equitably subordinate a tax penalty claim on a categorical basis in derogation of the congressional scheme of priorities set forth in the Bankruptcy Code. *Id.* at 543 . *See also United States v. Reorganized CF & I Fabricators, of Utah, Inc.*, 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463 (1996) (holding that penalty claim of the Internal Revenue Service could not be equitably subordinated to the claims of other general unsecured creditors).

(n9)Footnote 9. *In re Mobile Steel Co.*, 563 F.2d 692 (5th Cir. 1977) (under the former Bankruptcy Act); *New Commonwealth Publ'g Co. v. Baybank Middlesex (In re New Commonwealth Publ'g Co.)*, 23 C.B.C.2d 1419, 118 B.R. 155 (Bankr. D. Mass. 1990) .

(n10)Footnote 10. In *In re American Lumber Co.*, 5 B.R. 470 (D. Minn. 1980), the district court agreed with the bankruptcy court's subordination of a bank's claim because the bank overwhelmingly controlled all aspects of the borrower's business, in part through its right to a controlling interest in the borrower's stock. *Id.* at 478 . The lender controlled the debtor to the extent that it made the sole determination on whether checks written by the borrower would be honored, took for itself all payments made to the borrower, opened all the borrower's mail and terminated all employees who were not needed to liquidate the borrower. *Id.*

(n11)Footnote 11. *See In re Teltronics Servs., Inc.*, 29 B.R. 139, 169 (Bankr. E.D.N.Y. 1983) ("where the claimant is an insider, his dealings ... will be subjected to more exacting scrutiny" than a non-insider. Insiders' claims have been equitably subordinated where the claimant "engaged in fraud, mismanagement, self-dealing or other breaches of trust"). The court in *In re Beverages Int'l, Ltd.*, 50 B.R. 273 (Bankr. D. Mass. 1985) , subordinated the lender's claim because of the lender's inequitable conduct which included self-dealing, the sale of defective merchandise to the borrower and the breach of several contracts with the borrower. The lender had replaced the borrower's accountants and attorneys with the lender's own accountants and attorneys, participated in board meetings and directed the borrower to buy and sell various businesses and investments. In addition, a principal of the lender held more than 20% of the borrower's stock. *But see* cases cited in n.8 *supra*.

(n12)Footnote 12. In *In re W.T. Grant Co.*, for example, the bankruptcy court stated that non-insiders' claims should not be equitably subordinated unless the lender is guilty of "fraud, overreaching or spoliation to the detriment of others." 4 B.R. 53, 75 (Bankr. S.D.N.Y. 1980) , *aff'd*, 20 B.R. 186 (S.D.N.Y. 1982) , *aff'd*, 699 F.2d 599 (2d Cir.) , *cert. denied*, 464 U.S. 822, 104 S. Ct. 89, 78 L. Ed. 2d 97 (1983) . In *Credit Suisse v. Official Committee of Unsecured Creditors (In re Yellowstone Mountain Club LLC)*, Case No. 08-61570 (Bankr.D.Mont. May 13, 2009), the court equitably subordinated the claims of a lender notwithstanding the fact that it found that the loan had been negotiated at arm's length on the basis that the lender had devised a scheme that encouraged the debtors to take out an unnecessary

loan after conducting very little financial due diligence and based on financial productions that "bore no relation to the Debtors' historical or present reality." In particular, the court found that the lender made the loan, which it then syndicated, in order to earn substantial fees, even though it should have known that making the loan and permitting the debtors to make substantial distributions of the loan proceeds to the controlling shareholder would be detrimental to the debtors and their creditors. *Id.*



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CHAPTER 4 Representing the Lender

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P 4.50 Checklist of Issues for Lender Analysis.

[1] Initial Due Diligence Investigation by the Lender.

[a] Collateral.

- ☐ If the lender has the benefit of collateral securing its debt, confirm that all proper filings, including mortgages, Uniform Commercial Code (UCC) financing statements and, if appropriate, UCC continuation statements have been made and still appear of record.
- ☐ If proper filings were not made in the first instance to protect the lender's interest or have been made but are defective, such filings should be made or corrected promptly.
- ☐ Ascertain whether any other creditors have competing claims against the lender's collateral and, if so, the extent and priority of those claims.
- ☐ Assess the value of the collateral.
- ☐ Investigate the availability of setoff rights.
- ☐ Determine if the borrower's obligation is secured by a lease or contract that might be discharged in bankruptcy.

[b] Flow of Information.

- ☐ Obtain the best possible information regarding the borrower's projected cash flow and ability to service debt.
- ☐ Is current financial and business information available?

- ☐ Obtain additional information on an ongoing basis and meet with management on a regular basis.

[c] Other Liabilities of the Borrower.

- ☐ What are the borrower's liabilities and how will they affect a lender's workout versus bankruptcy calculus?
 - ☐ Examine the borrower's liabilities for taxes, pension benefits, environmental and cleanup costs, large scale personal injury liability exposure and burdensome union contracts.
 - ☐ Determine if the borrower is saddled with other burdensome contracts which may be avoided in bankruptcy proceedings.

[d] Subordination Provisions.

- ☐ If the lender is a subordinated lender, how do the terms of the subordination affect its analysis?
 - ☐ How deep is the subordination?
 - ☐ How is payment to the subordinated lender "blocked"?
 - ☐ Will the subordinated lender be able to retain creditor's status, or will it be obliged to accept an equity position?
 - ☐ What tax or other economic problems would restructuring create?
 - ☐ If the subordinated lender is obliged to accept a new security, how would that exchange affect its position in a subsequent bankruptcy?

[e] Analysis of the Lender's Own Vulnerability.

- ☐ Analyze certain transactions made pursuant to its loan documents as well as certain structural elements of the obligation it holds to determine whether they might represent potential litigation risks and loss of value to the lender in the future.
 - ☐ Has the borrower made any recent substantial payments to the lender?
 - ☐ Has the lender or a competing creditor recently received a partial or complete payment of an outstanding debt?

☐ Is there a formal relationship between the debtor and lender that indicates that the creditor has control over the debtor?

☐ Has the debtor transferred property to a creditor in satisfaction of an antecedent debt in the last 90 days?

☐ Has the lender received an upstream guarantee from a subsidiary or affiliate of the borrower?

[2] The Lender's Obligation of Good Faith and Fair Dealing.

☐ Are there any contractual constraints on the lender's discretion in terminating credit?

[3] Common Law Theories of Lender Liability.

[a] Fraud.

☐ Has the lender responded to any credit inquiries or made other express or implied representations about its debtor's financial position?

[b] Interference/Excessive Control/Mere Instrumentalities/Alter Ego.

☐ Does the lender exercise any control over the borrower apart from monitoring its loan?

☐ To what extent, if any, has the lender become involved in the borrower's day-to-day activities?

[c] Deepening Involency.

☐ Has the lender fraudulently prolonged the borrower's life beyond insolvency?

[4] Statutory Theories of Lender Liability.

[a] Federal Securities Laws.

☐ Is the lender in "control" of the borrower for purposes of liability under the federal securities laws?

[b] Federal Environmental Laws.

☐ Has the lender exercised decision making control over borrower's environmental compliance to the extent that the lender undertakes responsibility for the borrower's hazardous substances handling or disposal practices?

☐ Has the lender assumed overall management responsibility of the borrower encompassing the day-to-day decision making of an enterprise?

- ☐ Has the lender foreclosed but not divested itself of the property in an expeditious manner?

[5] Fraudulent Conveyances.

- ☐ If the lender's original loan is subject to attack as a fraudulent conveyance, the following due diligence is necessary:

☐ Was the loan incurred or collateral received (in either case a "transfer") with actual intent to hinder, delay or defraud any creditor?

☐ Was the transfer made for less than reasonably equivalent value?

☐ Was the debtor insolvent at the time of the transfer or did it become insolvent as a result of the transfer?

☐ Was the debtor undercapitalized or involved in a business with an unreasonably small capital?

☐ Did the debtor intend to incur or believe that it would incur debts beyond its ability to repay?

☐ In an LBO,

☐ did the lender consider the debtor's:

☐ financial picture at the time of the LBO;

☐ the reasonableness of the debtor's projections at the time of the LBO;

☐ the debtor's working capital requirements;

☐ the lender's analysis of the debtor's financial health?

☐ Did the target operate successfully for a period of time after the LBO?

☐ How soon after the LBO did the company experience serious cash flow problems?

[6] Other Theories of Liability for LBO Lender.

- ☐ Can an argument be made that the lender aided the officers and directors of the company in violating their fiduciary duties to shareholders and creditors?

[7] Equitable Subordination.

- ☐ Can the claimant be considered an insider by virtue of its control over the borrower or otherwise?
- ☐ Did the claimant engage in inequitable conduct?
 - ☐ Did the lender exceed its authority under the loan agreement?
 - ☐ Did the lender seek to perpetrate a fraud upon the general unsecured creditors of the debtor or did the lender merely attempt to save the debtor from failure or even to legitimately cover the lender's own losses?
- ☐ Did the inequitable conduct result in injury to other creditors of the debtor or did it result in the claimant gaining an unfair advantage?



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CHAPTER 5 Exchange Offers

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P 5.01 Introduction.

Over time, the makeup of holders of public debt issues has changed. Today, "widows and orphans" do not hold the majority of public bonds and such holders are usually sophisticated investors, including mutual funds, hedge funds and financial institutions that specialize in accumulating bonds as they begin to fall in value. Sophisticated public debt holders are able to assess and respond to restructuring proposals made by troubled companies. Many companies have successfully exchanged existing debt for new debt with stretched out amortization schedules, reductions in interest rates or pay-in-kind interest provisions and, in some cases, equity in place of all or a portion of their debt. The success of these exchange offers has depended on convincing the holders of a sufficient percentage of the bonds to tender into the exchange, thereby reducing the company's debt service sufficiently to ensure the viability of the company after the restructuring. The exchange offer usually also contains a request to amend the indenture governing the existing debentures to "strip" away many restrictive covenants. This tactic has been employed to convince potential "holdouts" to tender into the exchange so that they would not be left with securities without any covenant protection.

Companies with bonds issued under certain European jurisdictions ("eurobonds") may be able to avoid the "holdout" problem if their public bonds are not subject to the Trust Indenture Act of 1939 (the "Trust Indenture Act")ⁿ¹ and contain a collective action clause binding all holders if a sufficient percentage of the bonds vote to approve the exchange offer proposed by the company. Highly leveraged companies with eurobond issuances that contain collective action clauses may find that an exchange offer is still a viable option to a chapter 11 plan, as the exchange would allow the companies to exchange all of their Eurobond debt without obtaining the acceptance of 100% of the issue.

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. §§ 77aaa-77bbb.



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P 5.02 Scope and Use of This Chapter.

Once a troubled company has acknowledged the need to restructure its debt, the form of the restructuring transaction that it undertakes will often be determined by the type of debt, and the characteristics of the holders of such debt, that the company has outstanding. Many companies have incurred indebtedness through private credit agreements negotiated with banks and/or insurance companies. If a troubled company has only this type of privately-negotiated debt outstanding, a restructuring will generally take the form of face-to-face negotiations with the company's lenders or their agent and the eventual amendment of its credit agreements. This will not be the case, however, if the troubled company has "public" debt or debt held by holders of sufficiently large number and of such various types as to effectively prevent a restructuring from being completed by face-to-face negotiations.

The focus of this chapter and the next chapter is the restructuring of "public debt." This chapter outlines the basic substantive legal and procedural issues that both the issuer and the holder should consider when a troubled company restructures its public debt outside of chapter 11 through an exchange offer and consent solicitation.



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P 5.03 Public Debt.

Although public debt is commonly thought of as debt that has been registered under the Securities Act of 1933, as amended (the "1933 Act"),ⁿ¹ sold in an underwritten public offering and held by retail holders, in the restructuring context, the concept of public debt encompasses a broader range of securities.

Private debt can be characterized as debt issued to banks or other sophisticated financial institutions pursuant to an agreement that is negotiated prior to the issuance of the loans. In the past, an issuer of privately-held debt expected that its lender group would remain stable (due to customary restrictions on assignment or transfer of the debt) and that there would be a long-term business relationship with security holders.

On the other hand, public debt is commonly thought of as being held by numerous retail holders. However, public debt can also be held by sophisticated institutional investors who purchased the securities in the public market. If this debt was issued only or predominantly to institutional investors, it might not have been registered under the 1933 Act and can only be sold to other sophisticated investors. Nevertheless, because of the number or identity of the holders, there can be an active secondary trading market for such debt and it can still be considered public debt.

Public debt can also be characterized by the fact that it is generally subject to an indenture, pursuant to which the holders are represented by an indenture trustee. Public indentures tend to have market-driven covenants and may not be the subject of lender/issuer negotiation prior to the issuance of the notes. Many issues of public debt securities are subordinated to senior privately-placed debt. Most indentures require, either through negotiated terms or as mandated by the Trust Indenture Act that a high percentage of holders consent to any material amendment or waiver of the terms of the debt and that certain terms of the debt securities cannot be amended at all without the consent of each holder.ⁿ²

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. §§ 77a-77aa.

(n2)Footnote 2. Certain eurobond indentures may include collective action clauses that would allow a high percentage of holders to consent to bind all holders of such bond.



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P 5.04 Bondholder Committees.

Having generally assumed that the number and/or type of holders of public debt precludes face-to-face negotiations with each holder, a company planning a public debt restructuring must decide at the outset to whom the issuer should speak about the proposed restructuring and what it is legally permitted to say.

[1] Formation and Purpose.

Traditionally, the sequence of events involved in an exchange offer was fairly predictable. The initial offer was either filed with the Securities and Exchange Commission (the "SEC") or mailed to holders pursuant to an exemption from registration contained in the 1933 Act. The reaction of the market to the initial offer would demonstrate to the company whether the offer contained sufficient value to receive the support of bondholders. If it did not, the company would, through amendments to the initial solicitation materials, "sweeten" the offer until a sufficient percentage of holders tendered their securities to make the exchange successful.

As exchange offers became more common, bondholders began to form committees to be able to exercise more leverage with the issuer in determining whether or not to accept the offer. At first, committees representing holders of public debt securities would form after the issuer had commenced a solicitation of its security holders with respect to a proposed restructuring.

However, many institutional bondholders felt that the typical restructuring process left them as second-class citizens. Often, the issuer would negotiate its deal with its bank lender or bank syndicate and then make an offer to its bondholders through solicitation materials. This process deprived the latter group of input regarding the other creditor group and, in some instances, removed potent intercreditor negotiating issues, such as availability of collateral, subordination and covenant protections. More importantly, many institutional bondholders felt frustration at being handed a restructuring proposal that could not be negotiated in a coherent and systematic fashion by the bondholder group.ⁿ¹

Bondholder groups (including institutional bondholders) have become much more proactive and it is quite common for unofficial committees representing various tiers of debt to begin to form when the issuer has defaulted on outstanding debt or when security holders believe that the issuer is in a financially distressed situation. Such committees are generally formed by large institutional holders that are sophisticated in financial matters and that have sufficient "clout"

to negotiate with the issuer. Because such committees are formed to protect the interests of a particular class of security in the restructuring process and, in most instances, to negotiate the terms of the restructuring as it affects such class, such committees generally retain a financial advisor and legal counsel, the fees and expenses of which are typically paid by the issuer. Because bondholder committee involvement is an indispensable component to the successful reorganization of a company with a large number of bondholders, the company itself will often make the first contact with its bondholders by asking several large holders of its debt securities to organize into a committee for the purpose of negotiating a restructuring on behalf of the bondholders.

[2] Composition of Committee.

In contrast to committees formed in a chapter 11 case, out-of-court creditors' committees have no official standing, and their members do not have any statutory responsibilities or fiduciary duties with respect to the class of securities that they purport to represent. The composition of the committee, however, has great importance, as its very membership may determine whether it can credibly negotiate for all bondholders.

The troubled company has two concerns relating to committee composition. It must feel confident that the bondholder members hold or otherwise control a sufficient percentage of the affected class of securities to make negotiations meaningful and result in a recommendation of a restructuring proposal by the committee that can either bind the class or lend great weight to the company's proposal when put to the class vote. As discussed in *P 6.02[1]*, in a bankruptcy proceeding the affirmative vote of at least 2/3 in amount and at least a majority in number of the beneficial holders who vote is required to bind a class absent a cramdown. In addition, since a class of securities may be made up of different types of holders (*i.e.*, large institutions, investors in distressed securities, traders, etc.) who have different needs and priorities, the company wants some assurance that the committee will have a broad base of support by including members who in fact reflect the composition of the affected class of securities.

From the bondholders' perspective, it is also important that the committee be comprised of different types of holders so that the committee will accurately reflect the composition of the issue or issues of public debt it purports to represent. Members may include large and small holders, original holders who purchased at par from the issuer as well as those holders who recently purchased in the secondary market at a discount.

Another aspect to consider in committee formation is that more than one tier of debt may be held by the same holder. For example, a large bank syndicate may include an institution that also holds bonds, and in some cases, equity interests. Each constituency may want to establish a protocol governing whether information gleaned as a member of one group of holders can be shared with another group of holders. Companies may want to restrict a holder from disclosing company information learned as a member of one group to members of another group to which such holder belongs.

When a company has outstanding several classes or issues of public debt, one or more of which are subordinated to others, bondholders and the company must decide how many committees should be formed. The practice has developed of having one public debt committee that includes representatives of each class or issue of public debt securities. This committee generally negotiates an overall deal on behalf of the entire creditor group and then proceeds to intercreditor negotiations on the division of value among the various classes.ⁿ²

Many bondholders, although recognizing the importance of the role of the committee in the restructuring process, are reluctant to become committee members. This is primarily due to the potential restrictions on trading by committee members.

[3] Restrictions on Members.

[a] Confidentiality.

The first task of a committee after its formation is to gain information about the issuer and its financial and operating problems in order to assess any offer that has been presented by the issuer or to put forward its own proposal. This due diligence review, conducted by the committee's financial advisor and counsel, will include discussions with the company's management and will generally require that substantial non-public information be made available to the committee members and their advisors. Therefore, the company will insist that all committee members as well as their advisors sign confidentiality agreements concerning the information received during the restructuring process.ⁿ³ In addition, because of the consequences of such information falling into the hands of a competitor and the potential for liability under the federal securities laws, notably, Rule 10b-5ⁿ⁴ under the Securities Exchange Act of 1934, as amended (the "1934 Act"),ⁿ⁵ the issuer will also request that any transferee or assignee of a committee member be bound by the confidentiality agreement. Although the federal securities laws themselves restrict a recipient of material non-public information from trading activities, the company will want the additional protection of a contractual right to prevent disclosure of confidential information by the signatories to the confidentiality agreement. The company itself may be subject to enforcement action by the SEC under Regulation FD (for "fair disclosure") if it discloses material non-public information to specified categories of outsiders (including market professionals and securityholders who might reasonably be expected to trade in the company's securities on the basis of that information) and does not simultaneously disclose the information to the public.ⁿ⁶ Regulation FD does not apply to disclosures made to persons owing a duty of trust to the company, such as attorneys or investment bankers hired by the company, or to disclosures made to a person who expressly agrees to maintain the disclosed information in confidence.ⁿ⁷ In adopting Regulation FD, the SEC clarified that the confidentiality agreement does not have to be in writing.ⁿ⁸

There are generally two types of confidential information. As part of the negotiating process, committee members will learn about the company's and other creditor groups' positions on many issues relating to the restructuring before they are publicly announced. Committee members may also receive information relating to the company's financial condition prior to its disclosure to the public and before any offering materials become publicly available. In addition, even though certain information has been disclosed publicly, the committee may learn of material changes before such changes are publicly announced. For example, initial projections of future operating performance may have to be revised and negotiating parties may take different positions during the course of the restructuring.

A second type of confidential information relates to sensitive data that the company may never want to disclose. Such data may include trade secrets, supplier sources and customer lists and pricing information. This information might be critical in determining the value of the enterprise and the prospects of the company, but may need to remain confidential as disclosure could compromise an advantage that the company has over competitors.

[b] Insider Trading and Breach of Confidentiality.

Committee members may raise objections to the receipt of confidential information because access to material non-public information will restrict their ability to trade in the securities of the issuer. Certain institutions take the position that they have a fiduciary duty to their own shareholders not to be restricted from trading.

Trading by a committee member when in the possession of material non-public or inside information is "insider trading," prohibited by the federal securities laws including, in particular, Rules 10b-5 and 14e-3 promulgated under the 1934 Act. Recipients of material non-public information are subject to the "disclose or abstain from trading" rule,ⁿ⁹ requiring them to refrain from trading until the information in question becomes publicly available or is no longer considered to be material. Although the theoretical bases for imposing liability for insider trading under current case law are beyond the scope of this chapter, it can be assumed that committee members become "insiders" by virtue of having been given access by the issuer to material non-public information for corporate purposes under circumstances in which the company expects such members to keep this information confidential.ⁿ¹⁰ This prohibition is equally applicable to a committee member serving on an official creditors' committee in a chapter 11 case or on an unofficial committee in an out-of-court restructuring. However, members of an official creditors' committee in a chapter 11 case are, in addition,

viewed as fiduciaries with respect to the class members they represent and therefore may not obtain any special benefits from service on the committee.ⁿ¹¹ If the committee member, in either a chapter 11 case or an out-of-court restructuring, has also signed a confidentiality agreement, such agreement will specifically prohibit disclosure by the committee members and their financial advisors of any nonpublic information and will subject the signatories to possible legal action by the company (*i.e.*, injunctions and monetary damages) if the agreement is breached. Generally speaking, the scope of what is considered confidential information for purposes of these agreements is very broad and is not limited to material non-public information, the standard generally used in imposing insider trading liability.

[c] Minimizing the Impact of Restrictions.

Bondholder committees often utilize their financial advisor as a screen to protect them against receiving at least certain types of inside information. In almost every case, only the financial advisor will receive sensitive operating information that is never meant to become public.ⁿ¹²

In certain situations, committee members refuse to restrict themselves for any length of time, and authorize the financial advisor to receive all information from the company, negotiate a restructuring and get the approval from committee members during a weekend conference call, at a time when the trading markets are closed. During that call, the financial advisor may offer conclusions as to the restructuring proposal's feasibility, but will not divulge the financial and other information that supports such conclusions.

In other cases, committee members agree to sign a confidentiality agreement that expires on a certain date, permitting the bondholder to disclose any material information thereafter. Others have no intention of trading at any time and do not object to being restricted.

If all members of a committee cannot agree upon an acceptable scope of restrictions, a committee may even be made up of certain members who are "restricted" and have received material non-public information and other members who are "unrestricted" and have not received material non-public information. It is possible to work with a bifurcated committee by utilizing dual distributions of materials and split meetings.

Recognition of the importance of participation on committees has led to a search for a solution that would permit full institutional participation on such committees without at the same time restricting trading. Large multi-service financial institutions have a special sensitivity to this problem, as they may have different units or departments actively involved in the trading of securities. In the case of broker-dealers or investment advisors, such firms may possess a conflicting duty to their retail customers, to whom they give trading recommendations.ⁿ¹³ Making trading recommendations to such customers without disclosing that the firm is in possession of material non-public information that is inconsistent with such recommendation might subject the firm and the broker to potential liability.ⁿ¹⁴ In addition, although neither the Bankruptcy Code nor the Bankruptcy Rules contain an outright prohibition against trading in the debtor's securities by a member of a creditors' committee,ⁿ¹⁵ bankruptcy courts have sufficient powers to restrict such trading if they find it to be in breach of the committee member's fiduciary duties.

"Firewalls" and other information-blocking devices are recognized as an effective means of preventing the misuse of non-public information. The Insider Trading and Securities Fraud Enforcement Act of 1988ⁿ¹⁶ requires the implementation of information-blocking devices such as firewalls for broker-dealers and investment advisors.ⁿ¹⁷ Furthermore, such devices may serve as a defense to actions brought under the antifraud provisions of the 1933 Act and 1934 Act.ⁿ¹⁸ Moreover, the use of devices such as a firewall should also work as a defense in an adversary proceeding for disallowance or subordination of a committee member's claim.ⁿ¹⁹ Firewalls, however, may not be feasible for smaller investment firms in which the same person who serves on the committee may also make the investment decision on the trading side. For larger firms, the implementation of a firewall and compliance therewith may increase such institution's costs by requiring a separate restructuring staff.

In the *Federated Department Stores, Inc./Allied Stores Corporation* n20 chapter 11 cases in the Southern District of Ohio, the United States trustee had recommended an absolute ban on trading in the debtors' securities by any member of the creditors' committee until the plan of reorganization had been confirmed by the bankruptcy court, on the theory that trading would breach a committee member's fiduciary duty to its class members. Although a committee member outside of a bankruptcy proceeding is not viewed as a fiduciary, the underlying problem of misuse of material non-public information is equally applicable in the non-bankruptcy insider trading context and the procedures sanctioned by the bankruptcy court in the *Federated* case may be helpful in fashioning guidelines for committee members in an out-of-court restructuring.

In the *Federated* case, Fidelity Management & Research Co. ("Fidelity") sought an order permitting it to trade in the debtors' securities under certain circumstances and the court granted such relief, thereby approving the use of a firewall as an effective information-blocking device. Fidelity argued that the use of a firewall would prevent any misuse of non-public information and improper influence with respect to its decisions on the committee by its trading arm and agreed to the following procedures: no committee personnel would share information received by it with any other Fidelity personnel; no file containing non-public information produced from committee activities would be available to other employees; no committee member would receive any advance information about Fidelity's trading activities.n21

Fidelity argued as a policy matter, that if multi-service financial institutions could not avail themselves of a firewall, the ultimate effect would be to discourage participation on a creditors' committee of the largest holders of an issuer's securities. Following the guidelines laid out by Fidelity in *Federated* may give an institutional investor the means of effectively balancing its need to continue trading while protecting its economic interest in the restructuring company by serving on a creditors' committee.

FOOTNOTES:

(n1)Footnote 1. While bondholder groups are now often brought into the process at a much earlier stage, companies still tend to initiate negotiations with their bank lenders first, especially when seeking waivers of bank debt defaults. Banks may resist allowing bondholders to review bank term sheet drafts until the bank deal is in near final form.

(n2)Footnote 2. It may prove necessary to have different committees when one class of securities has potential claims against another class. This can arise, for instance, when one class of debt was issued prior to a leveraged buyout and another class was issued in connection with the leveraged buyout and is, therefore, vulnerable to a fraudulent conveyance attack. *See P 4.06 supra*, for a discussion of fraudulent conveyances and related issues.

(n3)Footnote 3. *See P 6.10 infra* for a sample form of confidentiality agreement.

(n4)Footnote 4. 17 C.F.R. § 240.10b-5.

(n5)Footnote 5. 15 U.S.C. §§ 78a-78mm.

(n6)Footnote 6. 17 C.F.R. §§ 243.100-103.

(n7)Footnote 7. *Id.* § 243.100(b)(2)(i) & (ii).

(n8)Footnote 8. *See* 1933 Act Release No. 7881, 1934 Act Release No. 43154, *Fed. Sec. L. Rep. (CCH) P 86,319*, at n.28 (August 15, 2000).

(n9)Footnote 9. *See Dirks v. SEC*, 463 U.S. 646, 653, 103 S. Ct. 3255, 3260-61, 77 L. Ed. 2d 911, 921 (1983) ; *Chiarella v. United States*, 445 U.S. 222, 227, 100 S. Ct. 1108, 1114, 63 L. Ed. 2d 348, 356 (1980) ; *United States v. O'Hagan*, 521 U.S. 642, 651-53, 117 S. Ct. 2199, 2207-08, 138 L. Ed. 2d 724, 740-41 (1997) (reaffirming *Dirks* and *Chiarella* but also articulating the "misappropriation theory" of insider trading liability).

(n10)Footnote 10. Examples of "access" or "quasi" insiders include "an underwriter, accountant, lawyer, or

consultant working for the corporation." *Dirks*, 463 U.S. at 655, 103 S. Ct. at 3262, 77 L. Ed. 2d at 922 n.14 . See generally 5C Arnold S. Jacobs, Disclosure and Remedies Under the Securities Law § 12.118 (2004) ["Jacobs"].

(n11)Footnote 11. See *Woods v. City Nat'l Bank & Trust Co.*, 312 U.S. 262, 268-69, 61 S. Ct. 493, 497, 85 L. Ed. 820, 826 , *reh'g denied*, 312 U.S. 715, 61 S. Ct. 736, 85 L. Ed. 1145 (1941) (members of creditors' committee are fiduciaries); *Westmoreland Human Opportunities, Inc. v. Walsh*, 327 B.R. 561 (W.D. Pa. 2005) (fiduciary duty is violated by committee member's using position to promote self-interest), *aff'd in relevant part and rev'd in part on other grounds*, 327 B.R. 561, 2005 U.S. Dist. LEXIS 20525 (W.D. Pa. 2005) . But see *DiStefano v. Stern (In re J.F.D. Enters., Inc.)*, 223 B.R. 610, 623 (Bankr. D. Mass. 1998) , *aff'd*, *DiStefano v. Stern*, 236 B.R. 112 (D. Mass. 1999) , *aff'd*, *DiStefano v. Stern (In re JFD Enters., Inc.)*, 2000 U.S. App. LEXIS 9162 (1st Cir. 2000) (although counsel to an official creditors' committee owes a fiduciary duty to the committee, characterizing committee counsel as a fiduciary of the creditors the committee represents is unwarranted); *Zabin v. Picciotto*, 12 Mass. L. Rptr. 212, 212-13, 2000 WL 1473445, *1-2 (Mass. Super. June 06, 2000) (counsel to a committee owes a fiduciary duty to carry out the interests and directions of the committee, without having to question whether the committee is effectively representing the interests of its constituents).

(n12)Footnote 12. An exception is when a bondholder is to become a director of a restructured company and begins certain oversight functions.

(n13)Footnote 13. See *Restatement (Third) of Agency § 8.11* (2006) (discussing generally agent's duty to inform principal of relevant facts); see also Jacobs § 18.4-.33.

(n14)Footnote 14. See generally Jacobs, *supra* n.10 , for a discussion of liability issues relating to brokers and their customers.

(n15)Footnote 15. Some commentators have suggested, based on the Bankruptcy Act and other prior bankruptcy provisions, that bankruptcy laws indeed prohibit committee members, as fiduciaries, from trading in claims of the debtor. See Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 *Cardozo L. Rev.* 1, 33-37 (1990).

(n16)Footnote 16. Pub. L. No. 100-704, 102 Stat. 4677 (codified as amended in scattered sections of 15 U.S.C.).

(n17)Footnote 17. 15 U.S.C. §§ 78o(f), 80(b)-4a.

(n18)Footnote 18. Rule 14e-3(a) of the 1934 Act imposes a duty to "disclose or abstain from trading" on any person who obtains material non-public information about a tender offer from either the offeror or the target company or any of its respective officers, directors or employees. 17 C.F.R. § 240.14e-3. Rule 14e-3(b) provides an exception for entities that can show that (i) the person making the investment decision on behalf of the entity did not know the material, non-public information, and (ii) such entity has implemented policies and procedures "reasonable under the circumstances," to ensure that the person making the investment decision does not violate Rule 14e-3, including policies and procedures that restrict the purchase and sale of any such security or that prevent the decision maker from knowing any such information. 17 C.F.R. § 240. 14e-3(b).

(n19)Footnote 19. This remedy has received increasing support from the bankruptcy bar. See generally Pozen & Mencher, *Chinese Wall for Creditors' Committees*, 48 *Bus. Law.* 747 (1993).

(n20)Footnote 20. See *In re Federated Dep't Stores, Inc.*, 1991 Bankr. LEXIS 288 (Bankr. S.D. Ohio Mar. 7, 1991) .

(n21)Footnote 21. See generally *In re Federated Dep't Stores, Inc.*, n. 20 *supra* at *1. The SEC submitted an *amicus* brief in support of Fidelity's position on this issue. *Id.*



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P 5.05 Beginning the Negotiation Process.

As already noted, in the past, the typical process for commencing negotiations with respect to a restructuring was for the company to determine the terms of the proposed restructuring and prepare the necessary documentation describing the proposal. The terms of the exchange offer were then made public by the distribution of the relevant offering documents to security holders. Negotiations with security holders did not take place until after the company's initial restructuring proposal had been publicly disseminated.

With the sophistication and activism of institutional investors today, it is now not uncommon for a bondholder committee and its advisors to be in place before the issuer has determined the terms of the proposed restructuring and, at times, long before the relevant offering documentation has been prepared. The appearance of an active committee prior to the announcement of any proposed restructuring not only causes trading problems for bondholder members, but also forces the company to address the extent to which it can engage in preliminary negotiations with the committee and with security holders generally, without violating the federal securities laws.

[1] Gun Jumping: Section 5 of the 1933 Act.

Section 5 of the 1933 Act provides that it is unlawful to offer to sell any security unless a registration statement has been filed as to such security and unless the offer is made by a qualifying prospectus.ⁿ¹ "Gun jumping" refers to actions on the part of the issuer (or persons acting on behalf of the issuer, such as officers, directors, employees, financial advisors and public relations firms) prior to the filing of a registration statement that constitute an offer for purposes of section 5 of the 1933 Act or that may be viewed as conditioning the market or arousing public interest for a proposed but still undisclosed offer.ⁿ² Gun jumping may include issuing press releases or other public statements and holding meetings with analysts.ⁿ³ Companies are, however, permitted to continue the dissemination of factual information, including financial information, to their security holders consistent with past practice.ⁿ⁴ Offers made in reliance upon an exemption from registrationⁿ⁵ do not raise gun-jumping issues, although an issuer must always be mindful of the antifraud provisions of section 17 of the 1933 Act and section 10(b) of the 1934 Act.ⁿ⁶

If a proposed restructuring involves the issuance of securities to the public, discussions with creditors prior to the filing of a registration statement with the SEC may constitute gun jumping. Strict adherence to the prohibitions of section 5 would prohibit an issuer from speaking to its security holders or creditor committees until *after* a registration statement has been filed disclosing the terms of the proposed restructuring.

Rule 135 of the 1933 Act provides a "safe harbor" for the issuer with respect to certain public statements issued prior to the filing of a registration statement.ⁿ⁷ Under Rule 135, a public announcement by an issuer that it intends to make a registered public offering of securities will not be deemed to be an "offer to sell" within the meaning of section 5 of the 1933 Act if the announcement states that the offering will be made only by means of a prospectus and only contains certain other specified information. Rule 135 permits the inclusion of any or all of the following information: (i) the name of the issuer; (ii) the title, amount and basic terms of the new securities, the anticipated timing of the offering and a brief statement of the manner and purpose of the offering without naming the underwriter or dealer manager; and (iii) the title of the old securities and the basis upon which the exchange may be made.ⁿ⁸ Rule 135 may therefore be of limited utility if the issuer wishes to say more about its proposed exchange offer.ⁿ⁹

[2] Possible Approaches to Preliminary Negotiations.

Some issuers believe that it is beneficial to first mail offering materials to security holders before the commencement of any negotiations, because it is understood that the offer is subject to negotiation, and an initial offer ascertains how far apart the company may be from the bondholder community in terms of their respective views on the value of the enterprise.

In addition, issuers may want to disseminate the offering materials to security holders prior to any negotiations to provide bondholders with a common fact base, including financial information and projections and the company's business plan, thereby facilitating multi-party discussions.

Bondholders, however, may disagree with this approach and prefer to have discussions prior to the distribution of the offering materials. Likewise, as a company facing a liquidity crisis feels tremendous pressure to shorten the negotiating process and begin face-to-face discussions as quickly as possible, the company may want to begin negotiations immediately, and not wait for the offering materials to be prepared and mailed to security holders.

In several out-of-court restructurings, the companies met with a small group of their sophisticated institutional bondholders and presented them with confidential information, together with a signed agreement that provided that the confidential information would be publicly disclosed within a short period of time by the filing of the materials with the SEC on Form 8-K. The companies justified these procedures by claiming that they were not making offers but were merely engaging in preliminary discussions with several large holders about possible alternatives.

[3] "Lock-Up" Arrangements.

It is sometimes possible for a company to fully negotiate the terms of a restructuring plan with a small group of sophisticated creditors prior to a general solicitation of votes. In such circumstances, it is advantageous for the company to ensure the commitment of the negotiating group to the proposed plan, including a commitment not to transfer the creditors' claims or to transfer them only subject to a commitment to the proposed plan. A "lock-up" arrangement of this sort will provide some stability in the negotiating process and, if announced in the solicitation materials generally distributed, may provide an incentive to other parties to accept the plan.ⁿ¹⁰

If the proposed restructuring is subject to section 5 of the 1933 Act, the company's ability to enter into lock-up arrangements will be restricted. While no *offer* to sell any security may be made unless a registration statement has been filed,ⁿ¹¹ section 5 of the 1933 Act also provides that no *sale* of any security may be concluded until a registration statement becomes effective.ⁿ¹² Generally, a commitment to accept an exchange offer will constitute a sale and cannot, therefore, become binding until the related registration statement becomes effective.ⁿ¹³ However, an argument could be made that a lock-up arrangement with a small group of sophisticated creditors is an exempt private placement pursuant to section 4(2), while the subsequent general solicitation pursuant to the registration statement is part of a public offering made in compliance with section 5 of the 1933 Act.ⁿ¹⁴ When a commitment is not possible prior to

effectiveness, the company may nevertheless find it advantageous to formalize a non-binding indication of interest from the negotiating group, which can be disclosed in the solicitation materials. A binding lock-up may then be concluded immediately upon effectiveness.

A 2002 ruling by Judge Mary Walrath of the Delaware bankruptcy court in *In re NII Holdings*ⁿ¹⁵ raised concerns about lock-up arrangements in Delaware. In that case, the court invalidated the votes of certain creditors that executed a lock-up agreement after the bankruptcy filing but before the disclosure statement had been approved. The court designated (i.e., invalidated) ballots cast by creditors who delivered lock-up and voting agreements to the debtors after commencement of the chapter 11 caseⁿ¹⁶ as not having been solicited in accordance with Section 1125(b)ⁿ¹⁷ of the Bankruptcy Code.ⁿ¹⁸ The court rejected a request to invalidate the votes of creditors who had signed the agreement prior to the filing, finding that it had no jurisdiction prior to the commencement of bankruptcy proceedings.ⁿ¹⁹ The 2005 amendments to the Bankruptcy Code created section 1125(g) which allows a prepetition solicitation to continue postpetition if the prepetition solicitation was conducted in compliance with applicable nonbankruptcy law.ⁿ²⁰ This change minimizes the incentives for dissenting creditors to delay or threaten to derail a prepackaged plan and increases the incentives for collective negotiation prior to the filing of a chapter 11 case.

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77e.

(n2)Footnote 2. See L. Loss, *Fundamentals of Securities Regulation* 103-108 (Aspen 2004) ["Loss"].

(n3)Footnote 3. *Id.*

(n4)Footnote 4. See 1933 Act Release No. 5180, *Fed. Sec. L. Rep. (CCH) P 3036, at 3065* (Aug. 16, 1971); 1933 Act Release No. 4697, *Fed. Sec. L. Rep. P 3257, at 3152* (June 5, 1964); 1933 Act Release No. 3844, *Fed. Sec. L. Rep. P 3250, at 3147* (Oct. 8, 1957).

(n5)Footnote 5. See generally P 5.08 *infra* for a discussion of exempt offerings.

(n6)Footnote 6. 15 U.S.C. §§ 77q, 78j(b). These sections prohibit fraudulent conduct "in the offer or sale of any security" in the case of section 17 and "in connection with the purchase or sale of any security" in the case of section 10(b). Such fraudulent conduct includes any material misstatement or omission, any scheme or device to defraud and any deceptive practice that operates as a fraud. Therefore, if the issuer were to make a public statement that was fraudulent and material, such statement might be actionable under sections 10(b) and/or 17. The judicially-created standards of liability and, in the case of section 17(a), the existence of an implied right of action are complex and beyond the scope of this chapter. However, for a general overview of these sections, see generally M. Steinberg, *Securities Regulation: Liabilities & Remedies* § 6.05 (Law Journal Press 2004); H. Bloomenthal, *Securities and Federal Corporate Law* § 13 (West 2007) ["Bloomenthal"].

(n7)Footnote 7. 17 C.F.R. § 230.135.

(n8)Footnote 8. *Id.* The Court of Appeals for the Second Circuit has held that the permitted disclosure specified in Rule 135 is an exclusive list and, therefore, an issuer that publicly discloses additional information will violate section 5 of the 1933 Act. *Chris-Craft Indus., Inc. v. Bangor Punta Corp.*, 426 F.2d 569, 574 (2d Cir. 1970) (*en banc*). For instance, a public disclosure describing the securities and the issuer in attractive terms may resemble the type of disclosure contained in a prospectus, and thus constitute "gun jumping." *Id.* at 574-75; see also *Capital Real Estate Investors Tax Exempt Fund Limited Partnership v. Schwartzberg*, 929 F. Supp. 105, 112-13 (S.D.N.Y. 1996).

(n9)Footnote 9. After the registration statement has been filed, the preliminary prospectus or "red herring" will be distributed to security holders. Once the registration statement has been filed, no written offers may be made except pursuant to a prospectus that complies with the requirements of section 10 of the 1933 Act. See 15 U.S.C. § 77j.

Therefore, a company must always consider whether the written information furnished to committee members and to security holders after the registration statement has been filed will violate the prospectus delivery requirements of section 10.

Rule 134 of the 1933 Act provides a "safe harbor" for issuers with respect to certain written communications that are not deemed to be prospectuses within the meaning of the 1933 Act. *17 C.F.R. § 230.134*. Such written communications are commonly referred to as "tombstone advertisements" and may include, among other things, the following information: (i) the name of the issuer; (ii) the title of the security and amount of the offering; (iii) a brief description of the issuer's general type of business; (iv) certain pricing information; and (v) the name(s) of the managing underwriter. *Id.*

(n10)Footnote 10. *See P 6.11 infra* for a sample form of lock-up agreement relating to a restructuring to be effected in a prepackaged bankruptcy. A similar letter may be used with an exchange offer. Prepackaged bankruptcies are discussed at *P 6.01 et seq.*

(n11)Footnote 11. *See P 5.05[1] supra.*

(n12)Footnote 12. *15 U.S.C. § 77e*. Offers may be made on the basis of a preliminary prospectus, or "red herring," that has been filed with, and is under review by, the SEC. No sale may be made until review is complete and the registration statement, including the prospectus contained therein, has been declared effective by the SEC.

(n13)Footnote 13. *See Loss* at 108-109 . The problem is not solved simply by conditioning the lock-up commitment on effectiveness of the registration statement. *See id. at 109 .*

(n14)Footnote 14. *See P 5.08[3][d] infra* for a discussion of the issues relating to when offerings will be treated as separate in this manner for the purposes of compliance with the 1933 Act and when they will be deemed to be one integrated transaction.

(n15)Footnote 15. *288 B.R. 356 (Bankr. D. Del. 2002) .*

(n16)Footnote 16. The court cited *section 1126(e) of the Bankruptcy Code*, which provides that "on request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions of [Title 11 of the United States Code]."

(n17)Footnote 17. Section 1125(b) prohibits solicitation of votes from a holder after commencement of the case unless a disclosure statement approved (after notice and a hearing) by the court has been transmitted to such holder at the time of or before such solicitation.

(n18)Footnote 18. Despite discounting the designated votes, the class to which the affected creditors belonged overwhelmingly approved the plan, with over 91 percent in value and over 79 percent in number voting in favor of the plan. The plan was subsequently confirmed.

(n19)Footnote 19. Further, the United States trustee in the *NII Holdings* case did not select creditors who had executed a lock-up agreement at any time, whether prior to or after the bankruptcy filing, to be a member of the creditors' committee. The concern was that a creditor that had already agreed to the terms of the plan and to vote in favor of such plan would not be able to properly exercise its fiduciary duties as a committee member.

(n20)Footnote 20. Pub. Law No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.



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CHAPTER 5 Exchange Offers

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P 5.06 Exchange Offers.

[1] Definition.

An exchange offer is an offer by an issuer to its existing security holders to exchange existing debt or equity securities for new securities and, in some instances, cash. The primary purpose of an exchange offer is to ameliorate the cash flow problems resulting from the terms of an issuer's existing debt and/or preferred stock by, for example, reducing or postponing interest payments or dividend payments; postponing, lengthening or reducing mandatory principal or redemption payments; or perhaps converting existing debt into equity.

An exchange offer is typically utilized when a financially troubled company is unable to raise sufficient cash, either through a bank refinancing or from internally generated resources (such as asset sales or cash flow from operations), to make cash interest or dividend payments on outstanding debt or to repurchase its securities, either in the open market or pursuant to redemption provisions in its debt documents. Exchange offers have also been undertaken to deal with the problems of "high yield" securities--securities that have above-market interest or dividend rates or other features that increasingly place a strain on the company's already tight cash flow. Some high yield securities include a "PIK" or payable-in-kind feature that defers the payment of cash interest or dividends, or a reset feature that requires the issuer to "reset" the interest rate after a certain date so that the securities can trade at par. Although designed to defer cash interest or dividend obligations until the borrower's overall debt levels have been reduced or cash flow has increased, such securities become for many companies "time bombs" that create huge and increasingly more difficult future debt burdens to service. For example, PIK securities create additional securities that require cash interest or dividends to be paid at a certain date. For those "reset" securities that are currently trading at a substantial discount from par, the original interest rate may have to be increased substantially on the reset date. In addition, if there is no cap on the reset interest rate, it may be impossible to arrive at a reset rate that would permit the securities to trade at par, as the increase in the rate will cause a deterioration in the creditworthiness of the issuer, thereby driving the market price down so that the securities will once again trade at a discount. In such a situation, completing an exchange offer may be the only means of permitting the effective restructuring of a troubled company's debt.ⁿ¹

[2] Amendments and Exit Consents.

Although public debt restructurings are typically accomplished through exchange offers, an issuer may determine that all that is required to effectuate the restructuring is to amend certain terms of its existing securities or the instruments that govern such securities. For example, an issuer may wish to eliminate certain restrictive covenants or amend certain

provisions of an indenture to avoid or eliminate an event of default. In order to effectuate any such amendment, the issuer will have to comply with applicable law as well as the terms of the indenture or other instrument.ⁿ² The indenture or certificate of designation will provide for the requisite level of votes necessary to effectuate the amendment.

Amendments of covenants are often sought in conjunction with an exchange offer when the basic terms of the burdensome securities must be changed and the issuer is also in need of relief from certain restrictive covenants or event of default provisions. An "exit consent" is a consent sought in connection with an exchange offer or tender offer whereby tendering security holders agree to eliminate or modify certain restrictions contained in the indenture, certificate of designation or other document relating to the securities being exchanged.ⁿ³ Because amendments of the basic terms of a security (*i.e.*, principal, interest rate, maturity date, redemption provisions, etc.) almost universally require the vote of each holder of the affected security, an exchange offer must "entice" or "threaten" security holders to voluntarily agree to such amendments.ⁿ⁴ In addition to providing relief from indenture provisions, exit consents are also thought to provide an added "stick" to convince security holders to exchange their securities or risk being left with a "covenantless" security.ⁿ⁵

[3] Types of Exchange Offers.

Since an exchange offer requires the issuance of new securities, it involves the "sale" of a new security for purposes of the 1933 Act.ⁿ⁶ The SEC has specifically determined that an "offer," "offer to sell," "offer for sale" or "sale" within the meaning of section 2(3) of the 1933 Act occurs when security holders are asked to elect whether to accept a new security in exchange for their existing security.ⁿ⁷ Thus, under the 1933 Act, the securities issued in an exchange offer are subject to the registration requirements of section 5 unless an exemption from registration is available.

There are two types of exchange offers: those that involve the issuance of securities that are required to be registered under the 1933 Act,ⁿ⁸ and those that involve the issuance of securities that fall within one of the exemptions from registration provided for in the 1933 Act.ⁿ⁹

FOOTNOTES:

(n1)Footnote 1. *See P 6.01 infra* for a discussion of certain obstacles to exchange offers that have made it increasingly difficult for this method of restructuring to succeed. Prepackaged bankruptcy is an alternative method of restructuring that has a number of advantages over the traditional exchange offer. *See PP 6.01 et seq.* for an in-depth discussion of prepackaged chapter 11 cases.

(n2)Footnote 2. *See P 5.09 infra* regarding the Trust Indenture Act.

(n3)Footnote 3. *See P 5.12[6] infra* for a discussion of the validity of exit consents.

(n4)Footnote 4. In the case of certain eurobond indentures, collective action clauses may bind the minority to changes that have been approved by a high percentage of the holders of the affected security, thereby alleviating the need for exit consents.

(n5)Footnote 5. *See PP 5.12, 5.13[3] infra* for a discussion of consent solicitations.

(n6)Footnote 6. *See Rule 145, 17 C.F.R. § 230.145.* Rule 145 provides that an "offer," "offer to sell," "offer for sale" or "sale" will be deemed to occur when a corporation or other person submits for a vote of consent of its security holders a plan or agreement for "a reclassification of securities of such corporation or other person other than a stock split, reverse stock split or change in par value, which involves the substitution of a security for another security." *Id.*

(n7)Footnote 7. *Id.* at Preliminary Note.

(n8)Footnote 8. *See P 5.07 infra.*

(n9)Footnote 9. *See P 5.08 infra.*



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CHAPTER 5 Exchange Offers

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P 5.07 Registered Exchange Offers.

[1] Advantages and Disadvantages of Registration.

As a general rule, unless an exemption is available, registration will be required when a new security is issued. The principal advantage of registering a newly-issued security is to provide the holder thereof with the free transferability of the security.ⁿ¹ Exchanging security holders are likely to view a new security more favorably if it is freely transferable at the outset, increasing the chances that an active trading market in such security will develop quickly and thereby provide greater liquidity to the holder.

In addition, by registering the new security, the issuer may utilize a financial advisor or other third party who may be compensated for actively marketing the new security by soliciting security holders. The ability to use a financial advisor in this capacity and to pay it a "success fee" is often critical to the successful completion of an exchange offer involving numerous holders or a complex package of securities.ⁿ²

These advantages must be weighed against the disadvantages of registration under the 1933 Act. While exchange offers are designed to improve an issuer's financial condition, the time and cost associated with the registration process may well place an additional strain on the issuer's resources without necessarily providing more protection for security holders. In addition, registration involves the most public type of disclosure. Not only will the issuer have to disclose all of its financial problems to the public, but it will also have to disclose the risks and consequences of a chapter 11 case. Such negative disclosure may accelerate the deterioration of the issuer's financial condition, thereby creating a self-fulfilling prophecy in which the issuer will have no other alternative but to seek protection under chapter 11.

Furthermore, as previously noted, the issuer's ability to communicate directly with its security holders and to engage in preliminary negotiations prior to a registered offering is limited by "gun jumping" concerns.ⁿ³ Moreover, the scope of liability, particularly on the part of financial advisors, is potentially greater in a registered offering than in an exempt offering.ⁿ⁴

[2] The Mechanics of Registration.

In order to register a security in an exchange offer, a registration statement on Form S-4 must be filed with the SEC.ⁿ⁵ The level of disclosure required of the issuer by Form S-4 will depend on whether the issuer meets the eligibility requirements for use of Form S-3, which permits the issuer to incorporate by reference any 1934 Act reports previously

filed with the SEC.ⁿ⁶ As a practical matter, many financially troubled issuers will not be able to take advantage of the abbreviated Form S-3 disclosure and will therefore have to satisfy the more extensive disclosure requirements of a Form S-1 registration statement.ⁿ⁷

From a security holder's perspective, the critical sections of the registration statement are the description of the exchange offer, the financial projections and pro forma financial information, the risk factors relating to the exchange offer and the analysis of the potential vulnerabilities of the issuer and other parties with respect to potential and existing litigation, particularly in bankruptcy.

In a registered exchange offer involving a troubled company, additional disclosure will often be required by the SEC. In addition to a discussion of the risk factors relating to the exchange offer, the SEC will require pro forma financial information (together with a discussion of the underlying assumptions) with respect to post-restructuring periods. As a general matter, the staff of the SEC closely scrutinizes exchange offer transactions, apparently viewing them as being susceptible to some of the same public policy concernsⁿ⁸ as "going private" transactions and, more particularly, to management leveraged buyouts. Recent practice suggests that even though such disclosure may not be specifically required by Form S-4, the SEC will require full disclosure of (i) all alternatives to the chosen restructuring proposal that were explored by the issuer (including those alternatives that were ultimately rejected); (ii) the negotiations conducted by the issuer and any class of security holders; (iii) the effect of the transaction on various classes of security holders, including the relative benefits and detriments of the transaction; and (iv) all reports or analyses prepared for the issuer by a third party, such as an investment banker, relating to the transaction and any limitations imposed on the role of such third party or on its analysis or any qualification contained in such analysis.ⁿ⁹

The disclosure regarding other alternatives considered is particularly onerous to a troubled company because the issuer has, in all likelihood, investigated a multitude of alternatives, ranging from covenant amendments to a "free fall" bankruptcy filing. If the issuer is required to discuss the chapter 11 alternative and the effects of a chapter 11 case on its operations, this may have an adverse effect on the actual operations of the company because creditors and stockholders may react very negatively to such disclosure. In addition, investigation of other alternatives may have included discussions with third party investors or acquirors. An issuer may be highly reluctant to disclose such negotiations to the public, not only because of particular terms that might have been discussed and investor sensitivities, but also because the interested, but rejected, investor may be revisited at a later date to provide an alternative to the issuer's initial restructuring plan.

The disclosure of reports and analyses presented to the issuer and its board of directors may also pose difficulties for the issuer and its financial advisors. The issuer's financial advisors will have prepared various restructuring proposals and valuation analyses for the board. Not only is the disclosure of such reports or analyses not relevant from the security holder's perspective in cases in which the related proposal has been rejected, but many of the documents will have been prepared for a more sophisticated audience or for an audience that was viewing alternatives from an overall perspective as opposed to the perspective of a particular creditor group. Providing a description of a rejected alternative that provided greater recoveries for one class of creditors over another may provide fuel for dissatisfaction within that class, regardless of whether the proposed restructuring is better for the company and all creditors as a whole. Providing valuation analyses that were used for comparative purposes, but which do not provide realistic restructuring alternatives may also be misleading. Detailed explication of financial analyses will also worry investment bankers because of their potential liability under the federal securities laws.ⁿ¹⁰

Once the registration statement has been filed with the SEC, the SEC staff will generally take a minimum of four weeks to review the registration statement. The staff will comment on the registration statement and the issuer will be required to respond to such comments, generally by filing an amendment to the registration statement with the SEC. The issuer will have to respond to all comments before the SEC will declare the registration statement effective. In addition, if during the review period the terms of the exchange offer are renegotiated or other facts change, the revised terms will have to be incorporated into an amendment to the registration statement (which will also be subject to review and

comment by the SEC), thereby further postponing the effective date of the registration statement.

During the review period, the preliminary prospectus may be distributed to security holders. Distribution of the prospectus may be instrumental in generating feedback from security holders regarding their views on the economic terms of the exchange. In addition, from the issuer's perspective, this period is an opportune time to negotiate the final terms of the exchange offer.

FOOTNOTES:

(n1)Footnote 1. Affiliates of the issuer may, however, be deemed to be "underwriters" under the 1933 Act whether or not they hold registered securities and, if they want to sell in the public market, may be subject to the limitations of the safe harbor provisions of Rule 144. *See* Rule 144(c), (e), (f), (h) and (i), 17 C.F.R. § 230.144(c), (e), (f), (h) and (i).

(n2)Footnote 2. The SEC has recently become more flexible regarding the scope of permitted activities of financial advisors in certain exempted transactions. *See* P 5.08[1][c][iv] *infra* for a discussion of permitted activities of third parties in a section 3(a)(9) exchange offer.

(n3)Footnote 3. *See* P 5.05[1] *supra* for a discussion of "gun jumping" and related issues.

(n4)Footnote 4. For example, there may be additional bases for liability under the 1933 Act, such as section 11. *See* 15 U.S.C. § 77k (imposition of civil liability for false registration statements). The extensive liability issues, although of considerable importance in the context of an exchange offer, are beyond the scope of this chapter. For an overview of some of these considerations, *see generally* L. Loss, *Fundamentals of Securities Regulation* 1181-1410 (Aspen 2004); H. Bloomenthal, *Securities and Federal Corporate Law* § 12 (West 2007) ["Bloomenthal"]; J. W. Hicks, *Civil Liabilities: Enforcement & Litigation Under the 1933 Act* §§ 4.27-.31, 5.19-.35 (West 2004) ["Hicks"].

(n5)Footnote 5. *See* Fed. Sec. L. Rep. (CCH) P 7162, at 6261 (General Instruction (A)(1) to Form S-4).

(n6)Footnote 6. *Bloomenthal*, n.4 *supra*, § 9.42. These requirements, as set forth in General Instruction I(A)(5) to Form S-3, stipulate that the registrant must not have defaulted on any installment of debt for borrowed money. 17 C.F.R. § 239.13(a) (1999). One of the following transaction requirements must also be satisfied such as: (i) the aggregate market value of the issuer's voting and non-voting common equity held by non-affiliates must be \$75 million or more; (ii) the securities offered must be "investment" grade non-convertible securities; or (iii) investment grade asset-backed securities. 17 C.F.R. § 239.13(b)(1), (2) and (5). Except in the case of investment grade asset-backed securities, the registrant must also have been subject to the reporting requirements of Sections 12 or 15(d) of the 1934 Act for at least 12 months. 17 C.F.R. § 239.13. *See generally* *Bloomenthal*, n.4 *supra*, § 9.33.

(n7)Footnote 7. *See* Fed. Sec. L. Rep. (CCH) PP 7121-7126, at 6235-239. A Form S-1 registration statement is generally used by issuers that are not reporting companies or that have not been reporting companies for 12 months. *Id.*

The disclosure requirements for a Form S-1 include the issuer's financial statements, selected financial information, management's discussion and analysis of the issuer's financial condition and the results of operations, market and dividend information, information relating to legal proceedings, management remuneration and security ownership as well as disclosure relating to the issuer's business and a description of its properties. *See* *Bloomenthal*, n.4 *supra*, § 9.35.

(n8)Footnote 8. Some of these public policy concerns include the inherent "coerciveness" of the restructuring process, when security holders are asked to exchange their securities when faced with the clear risk of losing their entire investment. In addition, concerns may be raised by the potential conflicts of interest that insiders face in proposing a restructuring that preserves jobs and equity value for the current management stockholders while potentially impacting the other security holders in a materially adverse way. The SEC has thus taken the position that adequate disclosure with respect to the fairness of the proposed restructuring transaction is necessary.

(n9)Footnote 9. *See P 5.11[4][b] infra.*

(n10)Footnote 10. Investment bankers acting as financial advisors are potentially liable under section 10(b) of the 1934 Act and sections 11 and 12 of the 1933 Act if they act as underwriters or dealer-managers. *15 U.S.C. § 78j* (section 10(b)); *15 U.S.C. § 77k* (section 11); *15 U.S.C. § 77l* (section 12). *See generally Hicks, n.4 supra* , §§ 4.32-4.33, 6.60-6.107.



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CHAPTER 5 Exchange Offers

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P 5.08 Exempt Exchange Offers.

[1] Section 3(a)(9).

[a] Application.

As previously mentioned, the 1933 Act includes exemptions from the registration and prospectus delivery requirements of section 5. One of these exemptions is provided for in section 3(a)(9). This exemption was included in the 1933 Act to allow certain voluntary readjustments of the obligations of an issuer without the expense and delay of registration. The exemption is a narrow one; it is transactional in nature¹ and is available exclusively when no payment or other remuneration is made either directly or indirectly to any party for soliciting the exchange of securities and when the issuer and holders of the old and new securities are the same.²

[b] Advantages and Disadvantages.

A restructuring utilizing the section 3(a)(9) exemption has several advantages. First, a section 3(a)(9) exchange of securities can be effected relatively quickly and inexpensively because the lengthy registration process is avoided and the disclosure requirements are generally less burdensome.³ The issuer's offering documents will be reviewed by the SEC only when the exchange is coupled with a consent solicitation that invokes the proxy rules.⁴

Second, under this exemption, the issuer has more flexibility to be directly involved in discussions and negotiations with its security holders prior to formally launching the offer without being concerned with "gun jumping."⁵ As a result, the initial offer may more closely reflect market conditions and existing security holder concerns and may include the results of at least preliminary negotiations with existing security holders.

The primary disadvantage of a section 3(a)(9) offer is that the issuer's financial advisor, as well as any other agent of the issuer such as a public relations firm, is not allowed to actively participate in the solicitation of existing security holders to exchange their securities. When the securities are widely-held and the transaction is complex, the need to use a financial advisor or a public relations firm to assist in the solicitation may cause some transactions to fall outside the exemption.

[c] Requirements.

[i] Existing Security Holders.

Only existing security holders can participate in a section 3(a)(9) exchange transaction. The issuer may not sell the same securities or class of securities to persons other than exchanging security holders as a part of the exchange transaction.ⁿ⁶

[ii] Same Issuer.

A second requirement is that the issuer of the new securities must be the same as the issuer of the existing securities. This requirement may create a problem when another party such as a guarantor or joint obligor seeks to participate in the exchange offer.

The SEC has provided some answers to this problem in the form of no-action positions. First, it is clear that the offer and issuance of securities of a guarantor or co-obligor of the securities being exchanged does not necessarily run afoul of the same issuer requirement.ⁿ⁷ Second, in a merger (including a reverse triangular merger) or reorganization context, the SEC has granted no-action relief when a new parent entity (that was not an original guarantor or co-obligor) has subsequently assumed the obligations (whether as a direct obligor or guarantor) of a subsidiary's securities.ⁿ⁸

Third, no-action relief has been granted when the issuer of the new securities and the issuer of the existing securities were sister companies and both the new and existing securities were guaranteed by a common parent entity.ⁿ⁹ Although there were technically two different issuers, the parent entity argued that neither subsidiary had a separate economic identity from the parent and, therefore, as a matter of economic reality, the "real" issuer was the parent itself. Further, the parent argued that both the subsidiary and the parent ought to be viewed as the same issuer because an investment decision with respect to the subsidiary's notes would be based on the financial condition of the parent guarantor.

Outside of the merger or reorganization context, however, if the new securities are issued, guaranteed or secured by the assets of another entity and that entity is not a primary obligor or guarantor of the existing securities, the same issuer requirement may not be satisfied.ⁿ¹⁰

[iii] Exchange of Securities.

A third requirement is that the exchange must exclusively involve the exchange of a security with existing security holders.ⁿ¹¹ This requirement is not interpreted literally; so long as the primary purpose of the offer is to effect an exchange of securities, the SEC has allowed additional consideration other than the securities to be paid by either the issuer or the tendering security holder.ⁿ¹² The issuer can, for example, pursuant to Rule 150, make a payment of cash to its security holders so long as such payment is considered part of the terms of the offer.ⁿ¹³ There does not appear to be a limit on the amount of cash that may be paid to security holders in a section 3(a)(9) transaction.

Alternatively, under Rule 149, security holders may be required to make payments to the issuer to effect certain equitable adjustments between holders of the same class of securities with respect to interest or dividends.ⁿ¹⁴ Although Rule 149 specifically refers to cash payments by security holders, the SEC has permitted other non-cash types of consideration to be paid by security holders in exchange for interest or dividends. Examples of non-cash consideration that may be provided by security holders include the consent of security holders to amendments to the existing security, indenture or other governing instrument, a waiver by security holders of payment defaults and the release by security holders of potential causes of action against the issuer and affiliated parties.ⁿ¹⁵ Unlike Rule 150, however, the language of Rule 149, *i.e.*, "an equitable adjustment," implies that there is a limitation on the amount of such additional payment made by security holders whether in the form of cash or other consideration.

[iv] Activities of Third Parties.

The final requirement of the section 3(a)(9) exemption is that compensation cannot be paid, either directly or indirectly, by the issuer for soliciting acceptances from security holders.ⁿ¹⁶ Financial advisors or other third parties involved in the exchange offer can only receive a flat fee that is not conditioned upon the success of the exchange offer.

Moreover, the activities of financial advisors or other agents of the issuer (and of financial advisors to creditors' committees in certain situations) are significantly restricted in a section 3(a)(9) transaction.ⁿ¹⁷ For example, the types of activities that the SEC has specifically prohibited are as follows:

- The agent may not make any recommendations either directly or indirectly regarding the acceptance or rejection of the exchange offer.ⁿ¹⁸
- The agent may not discuss or convey any recommendations of other people (including management) regarding the exchange offer.ⁿ¹⁹
- Although the agent may point out recommendations of other parties if those recommendations are in the offering document, it may not comment on those recommendations.ⁿ²⁰
- If the agent has rendered a fairness opinion to the issuer in connection with the section 3(a)(9) exchange offer, that agent may not contact existing security holders or their representatives.ⁿ²¹

Although solicitation activities by an agent are not permissible, the SEC has demonstrated a certain degree of flexibility regarding preliminary negotiations between the issuer or its agent and the legal and financial advisors to a creditors' committee. In *Seaman Furniture Company*,ⁿ²² the SEC took a no-action position when the company's financial advisor participated in discussions with the legal and financial advisors to a committee of bondholders (who were sophisticated institutional investors representing over 40% of the outstanding debt) and rendered advice to the company with respect to the terms, mechanics and structure of the exchange offer. The financial advisor in this case did not communicate directly with security holders. Instead, the company's financial advisor attended bank meetings and was an active participant in negotiations with the banks. The financial advisor had also discussions with the committee's advisors during which it discussed the company's financial information, presented restructuring proposals and received, discussed and forwarded to the company the committee's responses to the proposals. The company's financial advisor received a fixed fee and was not entitled to receive a success fee. Moreover, it did not render a fairness opinion on the exchange offer or act as dealer-manager. Seaman's letter to the SEC emphasized that the exchange offer had to be consummated quickly because of the company's weakening financial condition, and that section 3(a)(9) was the most efficient way to accomplish the exchange offer.

While the negotiations between the advisors to the bondholders' committee and the company's financial advisor in *Seaman* took place before the commencement of the exchange offer, the SEC later took a no-action position in *International Controls Corp.* ⁿ²³ with respect to similar discussions between a company's financial advisor and the financial and legal advisors to the creditors' committees that took place after the section 3(a)(9) exchange offer had commenced.

In addition, the SEC has also allowed an agent or financial advisor to render other services in connection with a section 3(a)(9) exchange offer. An agent may engage in activities that are advisory, administrative or ministerial in nature such as the following:

- determining what action individual security holders intend to take regarding the exchange offer and communicating that information to the issuer;
- being named as dealer-manager in the offering circular;

- rendering a fairness opinion on the fairness of an exchange offer to security holders from a financial point of view;ⁿ²⁴
- disseminating offering material to brokers, banks and other nominees for dissemination to security holders;
- confirming with intermediaries such as brokers, banks and other nominees that the offering materials are being disseminated to existing security holders and that such holders understand the mechanics of the offer;
- calling holders to confirm that they have received the offering materials and that they understand the mechanics or procedural requirements of the offer as well as responding to questions;
- notifying existing security holders of the mechanics or other procedural requirements of the offer; and
- answering unsolicited questions not related to the mechanics or procedural requirements of the offer by directing such holders only to the applicable sections of the offering document or directing the holder to the issuer.ⁿ²⁵

The section 3(a)(9) exemption does provide, however, that the issuer, through either its directors or through certain employees, may recommend and solicit existing security holders to accept the exchange offer, *provided* that (i) no additional consideration is received and (ii) their solicitation activities are only incidental to their regular responsibilities.ⁿ²⁶

[d] Mechanics.

The 1933 Act does not require the preparation of any specific disclosure documents in connection with a section 3(a)(9) exchange offer. The issuer typically distributes an offering document to existing security holders together with a letter of transmittal and other related materials. The offering document generally includes material information about the purpose, terms and mechanics of the exchange and information about the issuer. Additional disclosure may be required, such as income tax consequences of the exchange offer, pro forma financial information, certain risk factors and a description of the new and existing securities and any other material elements of the restructuring.

If the transaction involves the issuance of public debt securities, limited disclosure is required about the issuer and the new securities under the Trust Indenture Act.ⁿ²⁷ To qualify the indenture under the Trust Indenture Act, the issuer must file a Form T-3 with the SEC.ⁿ²⁸

If a section 3(a)(9) exchange offer simultaneously involves a solicitation of consentsⁿ²⁹ or proxiesⁿ³⁰ from the holders of debt convertible into or exchangeable for a class of equity securities that is registered pursuant to section 12 of the Exchange Act, the issuer will be subject to the filing and disclosure requirements of Regulation 14A.ⁿ³¹ If the exchange offer is a tender offer, the issuer will be subject to the tender offer rules as well.ⁿ³² Further, since the section 3(a)(9) exemption is only an exemption from the registration requirements under the 1933 Act, the antifraud provisions of the federal securities laws still apply.ⁿ³³ Finally, when conducting an exchange offer utilizing a section 3(a)(9) exemption, one must be mindful that the exchange offer is not "integrated" with another offering.ⁿ³⁴ If the section 3(a)(9) transaction were considered to be integrated with another offering, the effect might be to render the exemption unavailable.

[e] Resales.

Since section 3(a)(9) is a transactional exemption only exempting the issuance of the new securities from registration under the 1933 Act, resales of the new securities issued in the exchange are subject to the same restrictions on resale, if any, as were applicable to the previous securities.ⁿ³⁵ If the previous security was a "restricted security" within the meaning of the 1933 Act, the new security may only be sold in a registered offering or pursuant to an applicable exemption from registration.ⁿ³⁶

[2] Section 3(a)(10).

[a] Application.

Section 3(a)(10) of the 1933 Act also provides an exemption from the registration and prospectus delivery requirements of section 5, although it is not commonly used because it is of limited applicability and scope. The exemption generally applies to certain issuances of securities that are approved by a judicial or governmental body.ⁿ³⁷ In particular, section 3(a)(10) is applicable to securities issued in exchange for legal claims, property or securities when a court or other competent tribunal has approved the transaction after holding a fairness hearing.ⁿ³⁸ This exemption may be appropriate in the context of an exchange offer or restructuring when securities are issued as part of a settlement of private litigation, particularly shareholders' actions under the civil liability provisions of the federal securities laws,ⁿ³⁹ or when securities are issued by entities that are subject to independent regulation, *e.g.*, insurance companies or banks, and the reorganization or rehabilitation of which is not governed by the Bankruptcy Code.ⁿ⁴⁰

[b] Requirements.

In order for a transaction to fall within the purview of section 3(a)(10), the exchange must involve the issuance of "any security." This has been interpreted liberally and includes any security within the meaning of section 2(1) of the 1933 Act.ⁿ⁴¹ Second, section 3(a)(10) is applicable to securities only "in exchange for one or more bona fide outstanding securities, claims or property interests or partly in such exchange and partly for cash."ⁿ⁴² Here, unlike section 3(a)(9), there is no express requirement that the securities be issued only to existing security holders. Finally, the availability of this exemption is expressly conditioned upon (i) notice being given to all potential recipients of the securities that provides them with an opportunity to object at a hearing and (ii) a fairness hearing with respect to the terms of the proposed exchange conducted by a court or other governmental body who has the authority to approve the transaction.ⁿ⁴³ This requirement is intended to afford the potential recipients of such securities the protection ordinarily obtained by the disclosure requirements of the federal securities laws.ⁿ⁴⁴

[c] Other Considerations.

A section 3(a)(10) transaction would be most useful in a restructuring or exchange offer if the authorized court or agency could impose a settlement over the objections of dissenting class members without giving them the ability to "opt out" of the settlement, notwithstanding section 316(b) of the Trust Indenture Act (which generally requires that each holder has the unconditional right to receive payment on its securities and to sue for payment after payment is due).ⁿ⁴⁵ Even if dissenting class members do have the ability to "opt out" of the proposed settlement, the principal advantage of a section 3(a)(10) transaction is that in a class action settlement, dissenting members will be bound by the terms of the settlement unless they affirmatively "opt out." Therefore, as a tactical matter, the number of "holdouts" in a section 3(a)(10) exchange transaction may be reduced.

Although section 3(a)(10), like section 3(a)(9), is a transactional exemption, the SEC has taken no-action positions stating that the securities issued in a section 3(a)(10) transaction are not "restricted" within the meaning of the 1933 Act even though the securities exchanged may have been "restricted."ⁿ⁴⁶

[3] Section 4(2) of the 1933 Act.

[a] Availability of the Private Placement Option.

Section 4(2) of the 1933 Act provides an exemption from registration for any securities issued in "transactions by an issuer not involving any public offering." Although the term "public offering" is not defined in the 1933 Act, the factors to be considered in determining what constitutes a public offering are (i) number of offerees and their relationship to each other; (ii) the number of securities offered; (iii) the size of the offering; and (iv) the manner of the offering.ⁿ⁴⁷ In addition, Regulation D (Rules 501-506 under the 1933 Act) provides a "safe harbor" for three types of offerings.ⁿ⁴⁸ Rule 506 is the most commonly-used exemption because there is no aggregate dollar limit on the size of the offering.

A private placement exchange offer is generally recommended when there are sophisticated security holders involved in the exchange, when the success of the exchange depends on its timeliness and when it is useful to have the financial advisor communicate directly with security holders. In determining the availability of this exemption, an issuer should consider the effect of trading activities in the issuer's securities on the composition of its security holders, including the type of security holder as well as the number of such holders.

[b] Mechanics of a Private Placement.

An issuer may avail itself of the section 4(2) exemption without relying on the safe harbor provisions of Regulation D. However, there are no clear statutory guidelines with respect to a section 4(2) exemption and the availability of the exemption is based on administrative and judicially-developed doctrine. The courts have developed certain criteria to determine when a transaction does not involve a public offering. These include:

- the number of offers and whether all offers (not purchases) were made in compliance with the exemption;ⁿ⁴⁹
- whether the issuer has abstained from general solicitation or advertising activities;ⁿ⁵⁰
- whether the issuer has taken certain precautions against resales;ⁿ⁵¹
- whether the offerees are sophisticated;ⁿ⁵²
- whether the offerees have access to the similar kind of information contained in a registration statement and whether the particular class of offerees requires the protection afforded by registration;ⁿ⁵³
- the size and manner of the offering;ⁿ⁵⁴ and
- the number of offerees and their relationship to each other and to the issuer.ⁿ⁵⁵

As noted above, Regulation D creates a safe harbor for certain limited offerings. Regulation D does not limit the number of offerees and it permits an offering of securities to an unlimited number of purchasers that are "accredited investors."ⁿ⁵⁶ Accredited investors are either institutional investors or other investors who are deemed to have sophistication in financial matters and who are able to bear the economic risk of the investment.ⁿ⁵⁷ Regulation D does, however, limit the number of "nonaccredited" purchasers to 35,ⁿ⁵⁸ all of whom must be sophisticated in financial matters.ⁿ⁵⁹ Although the number of offerees is not limited, the offer cannot be made through "general solicitation or general advertising."ⁿ⁶⁰ Since an exchange offer is made to existing security holders, this last requirement will generally be satisfied.

The availability of section 4(2) and, to a lesser extent, Regulation Dⁿ⁶¹ in an exchange offer context may be unclear due to the difficulty in (i) ascertaining whether the offerees and purchasers are in fact accredited investors (in the case of Regulation D) or otherwise satisfy the criteria under section 4(2) (in the case of a section 4(2) offering), and (ii) calculating the number of offerees and purchasers. In a primary offering, the issuer and its investment bankers know

who their offerees and purchasers are and obtain from all purchasers offeree letters that contain representations as to the accredited or non-accredited status of the purchaser. When an issuer is planning a section 4(2) or Regulation D exchange offer, it cannot always identify the beneficial holders of its securities, particularly when the securities are held "in street name," and therefore the issuer may not be able to ascertain how many of its holders satisfy the relevant criteria. Both exemptions may require the issuer to include all beneficial owners in its calculation of the number of offerees and/or purchasers on the theory that the eligibility requirements apply not only to the offeree and/or purchaser, but to the parties actually making the investment decision.ⁿ⁶² Thus, when securities are held by nominees, an issuer may not know whether it has exceeded the limitation on 35 "unaccredited" purchasers in the case of a Regulation D offering. Similarly, in a section 4(2) exchange offer, the issuer may have difficulty in ascertaining the identity and calculating the number of its offerees and purchasers.

The securities issued in a Regulation D or section 4(2) offering are "restricted securities" within the meaning of the 1933 Act. Also, unlike section 3(a)(9) exchange offers, section 4(2) transactions are exempt from the Trust Indenture Act.

[c] Advantages and Disadvantages.

The advantages of issuing securities through a private placement are somewhat similar to a section 3(a)(9) exemption: the issuer avoids the expense and time of a registered offering and certain potential liabilities under the 1933 Act.ⁿ⁶³ However, unlike a section 3(a)(9) transaction financial advisors and other agents of the issuer are not prohibited from actively soliciting security holders and being compensated for such activities.

On the other hand, the restrictions on resale of the new securities offered in a private placement may be considered unattractive to existing security holders, particularly if their old securities were registered and are freely tradeable. For so-called "qualified institutional buyers," however, the resale restrictions may not be a problem if the issuer is willing to make Rule 144A available and the requirements of that Rule are satisfied.ⁿ⁶⁴

[d] Integration With Other Offerings.

The issuance of new securities in an exchange offer might involve both a private placement and an offer of registered securities or may be preceded or followed by another offering by the issuer. Such combinations give rise to the issue of integration, a concept whereby two separate offerings are instead deemed to be one integrated offering.ⁿ⁶⁵ The relevant factors for determining whether multiple offerings should be integrated include: (i) whether the offerings are part of a single plan of financing; (ii) whether the offerings involve the issuance of the same class of securities; (iii) whether the offerings are being made at or about the same time; (iv) whether the same type of consideration is to be received; and (v) whether the offerings are being made for the same general purpose. The effect of integrating an exempt offering with a public offering is to destroy the availability of the exemption and require registration of the securities offered in the exempt offering.

Rule 152 of the 1933 Act provides a safe harbor with respect to a section 4(2) offering consummated *prior* to an offering of registered securities. By specifically providing that a valid section 4(2) offering will not be integrated with a subsequent public offering, this Rule generally permits an issuer that has completed a private offering to register other securities without exposing itself to the risk of liability.ⁿ⁶⁶

The SEC has issued a no-action letter with respect to integration in the exchange offer restructuring context. In *Black Box, Inc.*,ⁿ⁶⁷ the SEC stated that, even though certain private placement exchange offers would not be completed prior to the filing of a registration statement covering the same securities, Rule 152 could be relied upon with respect to the exchange offers, provided that the private placement offerees were "unconditionally obligated" to purchase the new securities, subject to the satisfaction of certain conditions that were not within the control of such offerees.ⁿ⁶⁸

The SEC has more recently adopted Rule 155, which clarifies and expands the integration safe harbor. Among other

things, Rule 155 specifically addresses the various circumstances under which an unregistered private offering would be considered abandoned and would not be integrated with a subsequent registered offering or vice versa.ⁿ⁶⁹

FOOTNOTES:

(n1)Footnote 1. Although section 3 of the 1933 Act governs "exempted securities" and section 4 of the 1933 Act governs "transactional exemptions," sections 3(a)(9) and 3(a)(10), *inter alia*, are in substance transactional exemptions and were included in section 3 of the 1933 Act by legislative accident. L. Loss, *Fundamentals of Securities Regulation* 342 (Aspen 2004) ["Loss"]. Resales of the securities issued pursuant to a section 3(a)(9) exemption are therefore subject to the same restrictions on resale as the securities exchanged. *See P 5.08[1][e] infra* regarding restriction on resales associated with a section 3(a)(9) transaction.

(n2)Footnote 2. 15 U.S.C. § 77c(a)(9).

(n3)Footnote 3. The issuer, however, remains subject to the antifraud rules. *See Loss*, n.1 *supra*, at 343 .

(n4)Footnote 4. *See P 5.12[7][a] infra*.

(n5)Footnote 5. *See P 5.05[1] supra* for a discussion of "gun-jumping."

(n6)Footnote 6. *See* 1933 Act Release No. 2029, *Fed. Sec. L. Rep. (CCH) PP 2140-2141*, at 2583-84 (Aug. 8, 1939).

(n7)Footnote 7. *See, e.g.*, Echo Bay Mines, Ltd., SEC No-Action Letter, 1992 SEC No-Act LEXIS 814 (available July 27, 1992) (common stock of parent exchanged for preferred stock of finance subsidiary where parent guaranteed dividend obligations of preferred and preferred was mandatorily exchangeable for parent preferred); Calton, Inc. & Subsidiaries, SEC No-Action Letter, 1991 SEC No-Act LEXIS 1123 (available Sept. 30, 1991) (subordinated notes of parent on which subsidiaries are jointly and severally liable are exchanged for cash, stock of parent and subordinated notes on which parent and subsidiaries are jointly and severally liable); ECL Indus., Inc. & Norlin Corp., SEC No-Action Letter, 1985 SEC No-Act LEXIS 2810 (available Dec. 16, 1985) (subsidiaries' debentures guaranteed by parent were exchanged for parent's warrants and subsidiaries' debentures); Baxter Travenol Laboratories, Inc., SEC No-Action Letter, 1983 SEC No-Act LEXIS 2557 (available July 8, 1983) (shares of subsidiary's preferred stock that are guaranteed by parent and convertible into parent's common stock converted into parent's common stock). *See also* SunTrust Banks, Inc., SEC No-Action Letter, 1999 SEC No-Act LEXIS 635 (available July 16, 1999) (preferred securities issued by existing trust exchanged for preferred securities issued by newly-created trust where the securities surrendered and issued were guaranteed by the sponsor bank for both existing and new trusts and both trusts were not independent of sponsor bank).

(n8)Footnote 8. *See, e.g.*, FHC-CompCare, Inc., SEC No-Action Letter, 1989 SEC No-Act LEXIS 1018 (available Oct. 12, 1989) (new parent guarantees acquired subsidiary's obligations under subsidiary's convertible debentures prior to reverse triangular merger; terms of merger permit conversion of subsidiary's debentures into cash and common stock and convertible debentures of new parent); *see also* Daisy Sys. Corp., SEC No-Action Letter, [1989-1990 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 79,314* (available Apr. 10, 1989); Newell Co., SEC No-Action Letter, 1987 SEC No-Act LEXIS 2254 (available July 22, 1987). The petitioners in both *FHC-CompCare, Inc.* and *Daisy* argued that the parent should be deemed the same issuer because the parent will in fact be liable for the subsidiary's debt by operation of law.

(n9)Footnote 9. *See* IMCO Realty Servs., Inc., SEC No-Action Letter, [1990 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 79,434* (available Feb. 6, 1990). The assets of both subsidiaries consisted solely of the notes of the parent or notes secured by the parent's notes. *See also*, SunTrust Banks, n.7 *supra*.

(n10)Footnote 10. *See* Gulf & W. Indus., Inc., SEC No-Action Letter, 1976 SEC No-Act LEXIS 1891 (available Sept. 6, 1976) (proposed exchange offer by parent company of its guarantee for proposed amendments to debt securities

of subsidiary does not satisfy the same issuer requirement); *see also* 1933 Act Release No. 646, *Fed. Sec. L. Rep. (CCH) P 2136*, at 2582 (Feb. 3, 1936) (section 3(a)(9) is "applicable only to exchanges which are bona fide, in the sense that they are not effected merely as a step in a plan to evade the registration requirements of the [1933] Act.").

(n11)Footnote 11. 15 U.S.C. § 77c(a)(9). The statutory language has been interpreted by the SEC to require an exchange exclusively with security holders and exclusively for securities. *See* Seaman Furniture Co., SEC No-Action Letter, [1990 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 79,406* (available Nov. 8, 1989).

(n12)Footnote 12. *See* Seaman Furniture Co., n.11 *supra*.

(n13)Footnote 13. Rule 150, 17 C.F.R. § 230.150.

(n14)Footnote 14. Rule 149, 17 C.F.R. § 230.149.

(n15)Footnote 15. *See* Seaman Furniture Co., n.11 *supra* ; First Pennsylvania Mortgage Trust, SEC No-Action Letter, 1977 SEC No-Act LEXIS 492 (available Feb. 4, 1977).

(n16)Footnote 16. 15 U.S.C. § 77c(a)(9) ("where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange").

(n17)Footnote 17. *See* International Controls Corp., SEC No-Action Letter, [1990-1991 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 79,604* (available August 6, 1990).

(n18)Footnote 18. *See* International Controls Corp., n. 17 *supra*.

(n19)Footnote 19. *See* Stokely-Van Camp, Inc., SEC No-Action Letter, 1983 SEC No-Act LEXIS 2274 (available Apr. 29, 1983).

(n20)Footnote 20. *See* Trans-Sterling, Inc., SEC No-Action Letter, 1983 SEC No-Act LEXIS 2460 (available June 16, 1983).

(n21)Footnote 21. *See* Dean Witter & Co., SEC No-Action Letter, 1975 SEC No-Act LEXIS 365 (available Feb. 24, 1975).

(n22)Footnote 22. *See* Seaman Furniture Co., n.11 *supra*.

(n23)Footnote 23. *See* International Controls Corp., n.17 *supra*.

(n24)Footnote 24. A financial advisor that issues a fairness opinion in such circumstances may not be permitted to initiate contact with security holders. *See* Dean Witter & Co., n.21 *supra*.

(n25)Footnote 25. *Calton, Inc. & Subsidiaries*, n.7 *supra* ; *International Controls Corp.*, n.17 *supra* ; *see also* *Trans-Sterling, Inc.*, n.20 *supra* ; *Seaman Furniture Co.*, n.11 *supra*.

(n26)Footnote 26. *See* Valhi, Inc., SEC No-Action Letter, [1976-1977 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 80,802*, at 87,092 (Oct. 15, 1976); Chris-Craft Indus., SEC No-Action Letter, [1972 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 79,052*, at 82,227 (Sept. 8, 1972); Time, Inc., SEC No-Action Letter, [1979 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 82,095*, at 81,863 (Mar. 19, 1979).

(n27)Footnote 27. *See* Trust Indenture Act of 1939, 15 U.S.C. §§ 77aaa-77bbb.

(n28)Footnote 28. *See* 17 C.F.R. § 269.3.

(n29)Footnote 29. *See* P 5.12 *infra* for a discussion of consent solicitations.

(n30)Footnote 30. *See P 5.12[7] infra* for a discussion of the proxy rules.

(n31)Footnote 31. *See P 5.12[7][b] infra*.

(n32)Footnote 32. *See P 5.11 infra*. If the section 3(a)(9) is a tender offer for nonconvertible or nonexchangeable debt securities only, Regulation 14E applies but no specific disclosure is required. *See P 5.11[2] infra*. If the offer is by the issuer for equity securities and the issuer has outstanding securities registered under the 1934 Act, Rule 13e-4 applies. *See P 5.11[3] infra*. If the offer will result in a class of equity securities being held by less than 300 persons or in the de-listing of such securities. Rule 13e-3 applies. *See P 5.11[4] infra*.

If the issuer uses a financial advisor who is a member of the National Association of Securities Dealers (the "NASD"), the advisor's compensation arrangement may be subject to review and clearance by the NASD. *See P 5.10[2] infra*.

(n33)Footnote 33. *See generally Loss, n.1 supra*, at 343 .

(n34)Footnote 34. The concept of integration is explained in the context of a private placement at *P 5.08[3][d] infra* .

(n35)Footnote 35. *See Mr. Coffee, Inc., SEC No-Action Letter, 1991 SEC No-Act LEXIS 766 (June 6, 1991); 1933 Act Release No. 646, Fed. Sec. L. Rep. (CCH) PP 2136-2137, at 2583 through 2583-3 (Feb. 3, 1936).*

(n36)Footnote 36. The term "restricted securities" is defined in subsection (a)(3) of Rule 144 as

(i) securities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering; (ii) securities acquired from the issuer that are subject to the resale limitations of [Rule] 502(d) ... or [Rule] 701(c) [under the 1933 Act]; (iii) securities acquired in a transaction or chain of transactions meeting the requirements of [Rule] 144A; (iv) securities acquired from the issuer in a transaction subject to the conditions of Regulation CE; and (v) equity securities of domestic issuers acquired in a transaction or chain of transactions subject to the conditions of [Rule] 901 or [Rule] 903 under Regulation S. *17 C.F.R. § 230.144*.

Section 4(1) is the most commonly-used exemption and permits resales by persons who are not deemed to be issuers, underwriters or dealers within the meaning of the 1933 Act. *15 U.S.C. § 77d(1)*. Affiliates cannot rely on this provision because they are deemed to be underwriters. Resales in the public market by affiliates are therefore governed by Rule 144. Rule 144A may also be available for sales by "qualified institutional buyers." *See generally E. Greene, R. Ketchum, L. Quinn & L. Spencer, Rule 144A: The Expanded Private Placement Market (P-H 1990).*

(n37)Footnote 37. Any exchange of securities by an issuer who has filed for protection under chapter 11 of the Bankruptcy Code is excluded from this exemption because such exchange is specifically governed by *section 1145 of the Bankruptcy Code*. *See P 6.07[2], n.9 infra* for a discussion of *section 1145 of the Bankruptcy Code*.

(n38)Footnote 38. *15 U.S.C. § 77c(a)(10)*. This section provides that the provisions of the 1933 Act do not apply to certain securities:

Except with respect to a security exchanged in a case under title 11 [of the United States Code], any security which is issued in exchange for one or more bona fide outstanding securities, claims or property interests, or partly in such exchange and partly for cash, where the terms and conditions of such issuance and exchange are approved, after a hearing upon the fairness of such terms and conditions at which all persons to whom it is proposed to issue securities in such exchange shall have the right to appear, by any court, or by any official or agency of the United States, or by any State or Territorial banking or insurance commission or other governmental authority expressly authorized by law to grant such approval.

(n39)Footnote 39. See J. Hicks, Exempted Transactions Under the Securities Act of 1933 § 3.4

(n40)Footnote 40. See 11 U.S.C. § 109(b) & (d) for those entities that are excluded from being a debtor under chapters 7 and 11 of the Bankruptcy Code. See, e.g., The Equitable Life Assurance Society of the United States, SEC No-Action Letter, 1992 SEC No-Act LEXIS 277 (available Feb. 27, 1992) (demutualization of life insurance company).

(n41)Footnote 41. See generally Hicks II, n.39 *supra*, § 3.6.

(n42)Footnote 42. The exchange is deemed to be *bona fide* when the interest that is to be exchanged for new securities was acquired in some way other than to facilitate the new securities being issued without registration. See Osias Org., Inc., SEC No-Action Letter, 1971 SEC No-Act LEXIS 2718 (available April 2, 1983).

(n43)Footnote 43. See generally Hicks II, n.39 *supra*, § 3.13-3.15.

(n44)Footnote 44. See generally Ash, *Reorganization and Other Exchanges Under Section 3(a)(10) of the Securities Act of 1933*, 75 Nw. U.L. Rev. 1 (1980).

(n45)Footnote 45. Although it is not clear that a court has the power to bind dissenters to a settlement outside of a bankruptcy proceeding without giving them the option to "opt out" of the settlement, in the context of this exemption there is some authority to support the position that a settlement may be binding upon an entire class of holders without giving such members the right to "opt out" of such settlement. See *Kemper Investors Life Ins. Co. v. Las Colinas Corp.*, No. 88C9162 (N.D. Ill. July 21, 1989); *Continental Assurance Co. v. Macleod-Stedman, Inc.*, 694 F. Supp. 449 (N.D. Ill. 1988); *MBank Dallas v. LaBarges Inc.*, No. 86C9583 (N.D. Ill. Dec. 29, 1986). See L. Buchheit and G. Gulati, *Sovereign Bonds and the Collective Will*, 51 *Emory L.J.* 1317 at 1354 (2002).

(n46)Footnote 46. See National Sec. Ins. Co., SEC No-Action Letter, 1990 SEC No-Act LEXIS 669 (Apr. 12, 1990).

(n47)Footnote 47. See 1933 Act Release No. 285, *Fed. Sec. L. Rep. (CCH) PP 2740-2744*, at 2911-2913 (Jan. 24, 1935); see also Preliminary Note 7 to Rule 144A of the 1933 Act, 17 C.F.R. § 230.144A (purchases of a security with a view to reselling in a Rule 144A transaction will not affect an issuer's section 4(2) exemption).

(n48)Footnote 48. See 17 C.F.R. §§ 230.501-.506. See generally R. Jennings H. Marsh, *et al*, *Securities Regulation* 403-432 (Foundation Press 8th ed. 1998). Rules 504 and 505 impose aggregate dollar limits. A Rule 504 offering cannot exceed \$1 million in any twelve-month period. A Rule 505 offering cannot exceed \$5 million in any twelve-month period. Rule 506 does not impose a dollar limit but limits the number of purchasers to no more than 35 "unaccredited" purchasers. See n.56 *infra* and accompanying text for the definition of accredited investor.

(n49)Footnote 49. See *Doran v. Petroleum Mgmt. Corp.* 545 F.2d 893, 900-02, 56 O.&G.R. 591 (5th Cir. 1977); *Swenson v. Engelstad*, 626 F.2d 421, 425-26 (5th Cir. 1980).

(n50)Footnote 50. See Schneider, *The Statutory Law of Private Placements*, 14 Rev. of Sec. Reg. 869-77 (1981).

(n51)Footnote 51. *Livens v. William D. Witter, Inc.*, 374 F. Supp. 1104, 1110 (D. Mass. 1974).

(n52)Footnote 52. *Hill York Corp. v. American International Franchises, Inc.*, 448 F.2d 680, 690-92 (5th Cir. 1971) (describing great offeree sophistication as "helpful" to a section 4(2) exemption claim but not by itself sufficient); *Doran*, 545 F.2d at 902-04; *Cook v. Avien, Inc.* 573 F.2d 685, 691 (1st Cir. 1978); *S.E.C. v. Murphy*, 626 F.2d 633, 646 (9th Cir. 1980) (treating the sophistication of the parties as a necessary element when defending a claim for a section 4(2) exemption).

(n53)Footnote 53. See *United States v. Custer Channel Wing Corp.*, 376 F.2d 675, 678-79 (4th Cir. 1967); *Hill York Corp.*, 448 F.2d at 690-92; *Doran* 545 F.2d at 902-04. See also *Kunz v. SEC*, 64 Fed. Appx. 659, 667 (10th Cir.

2003).

(n54)Footnote 54. *See SEC v. Murphy*, 626 F.2d 633, 646-47 (9th Cir. 1980); *Hill York Corp.*, 448 F.2d at 689; *Doran*, 545 F.2d at 900.

(n55)Footnote 55. *SEC v. Ralston Purina Co.*, 346 U.S. 119, 125, 73 S. Ct. 981, 984-85, 97 L. Ed. 1494, 1499 (1953) (recognizing the number of offerees as one factor in determining whether an offer is public or private, but declining to impose a specific numerical limit on the amount of offerees allowable in a "private offering"); *Doran*, 545 F.2d at 900-04.

(n56)Footnote 56. Accredited investors include not only certain institutional investors but also persons whose net worth exceeds \$1 million, and those who had an individual income exceeding \$200,000 in each of the two most recent years (or \$300,000 joint income with one's spouse) and who reasonably anticipate such an income for the current year. Rule 501, 17 C.F.R. § 230.501.

(n57)Footnote 57. *See* 1933 Act Release No. 6389 [1981-1982 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 83,106, at 84,911-914 (Mar. 8, 1982); 1933 Act Release No. 6758 [1987-1988 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 84,221, at 89,014-15 (Mar. 3, 1988).

(n58)Footnote 58. *See* 17 C.F.R. § 230.501(e)(1); 17 C.F.R. § 230.506(b)(2)(i).

(n59)Footnote 59. 17 C.F.R. § 230.506(b)(2)(ii). Either the purchaser or the purchaser's representative must have the kind of knowledge and experience in financial and business matters necessary to evaluate capably the merits and risks of the prospective investment.

(n60)Footnote 60. 17 C.F.R. § 230.502(c).

(n61)Footnote 61. Because Regulation D imposes a quantitative limitation on the number of purchasers, not offerees, the number of offerees is not generally relevant (although if there is a large number of offerees, the issuer may run afoul of the prohibition against general solicitation and advertising). However, since the number and nature of purchasers is relevant for purposes of determining the availability of Regulation D, the issuer should consider whether beneficial owners need to satisfy the eligibility requirements set forth in Rule 506(b)(2)(ii). 17 C.F.R. § 230.506(b)(2)(ii).

In contrast, section 4(2) requires that the transaction in question not involve a "public offering." Therefore, the number and nature of offerees (as well as the number and nature of purchasers) is critical in determining the availability of this exemption.

(n62)Footnote 62. *See generally Hicks II*, n.39 *supra*, §§ 11.38 & 11.40.

(n63)Footnote 63. *See* P 5.08[1][b] *supra*.

(n64)Footnote 64. *See generally* H. Bloomenthal, *Going Public and the Public Corporation*, § 5.67 (West 2004) for the definition of qualified institutional buyer.

(n65)Footnote 65. *See* 1933 Act Release No. 4552, *Fed. Sec. L. Rep. (CCH)* P 2770 (Nov. 6, 1962); 1933 Act Release No. 4434, *Fed. Sec. L. Rep. (CCH)* P 2270 at 2602 (Dec. 6, 1961); First National Bank of Selmer, SEC No-Action Letter, 1982 SEC No-Act LEXIS 1785 (available February 8, 1982); Anthem Insurance Companies, Inc., SEC No-Action Letter, 2001 SEC No-Act LEXIS 778 (available Oct. 25, 2001). *See generally* Loss, 359-365.

(n66)Footnote 66. *See* 17 C.F.R. § 230.152; 1933 Act Release No. 305 (Mar. 2, 1935); *see also* 1933 Act Release No. 4761, [1964-1966 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 77,197, at 82,274 (June 4, 1964); *see also* Loss, n.1

supra, at 363 .

(n67)Footnote 67. See *Black Box, Inc.*, SEC No-Action Letter [1990 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 79,510, at 77,582 (available June 26, 1990). The SEC noted that if the purchase agreements executed by such offerees were renegotiated or if additional terms were added after execution of such purchase agreements and after the filing of the registration statement, such amended terms could constitute a new offering and Rule 152 would not be available as a safe harbor. The SEC, for policy reasons, also concluded that a proposed private placement of convertible debt to an identified limited number of qualified institutional investors and accredited investors need not be integrated with a contemporaneous registered common stock offering. See also *Squadron, Ellenoff, Pleasant & Lehrer*, SEC No-Action Letter, 1992 *SEC No-Act LEXIS* 363 (available Feb. 28, 1992) (staff narrowly construes integration policy position enunciated in *Black Box, supra* ; limited to registered offering that would otherwise be integrated with an unregistered offering to persons who would be "qualified institutional buyers" for purposes of Rule 144A and no more than two or three large institutional accredited investors).

(n68)Footnote 68. The Equitable Life Assurance Society of the United States, SEC No-Action Letter, 1992 *SEC No-Act LEXIS* 277 (available Feb. 27, 1992) (private placement of notes and preferred stock and issuance of common stock upon exchange of notes or conversion of preferred need not be integrated with public offering of common stock; staff assumes that purchaser's obligation to purchase securities will be subject only to conditions in purchase agreement, the satisfaction of which are not within purchaser's control).

(n69)Footnote 69. *Regulation of Securities Offerings, Securities Act Release No. 7943, Fed. Sec. L. Rep. (CCH)* P 86,416 (January 26, 2001).



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CHAPTER 5 Exchange Offers

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P 5.09 Registration Under the Trust Indenture Act.

[1] The Effect of the Provisions of the Trust Indenture Act on a Proposed Restructuring of Debt.

Since an exchange offer usually requires the issuance of new debt securities, an indenture covering such securities is required to be filed with the SEC and qualified under the Trust Indenture Act, absent an applicable exemption.ⁿ¹

The Trust Indenture Act provides the debt holder with certain fundamental protections, as each indenture qualified under the Trust Indenture Act is required to provide certain protections or to incorporate the applicable provisions of the Trust Indenture Act by reference. For instance, section 316(b) of the Trust Indenture Act requires that the indenture provide for the right of any holder to receive each installment of principal and interest on its scheduled payment date, and to allow that holder to institute suit for the enforcement of such payment on or after such date.ⁿ²

However, the Trust Indenture Act does permit other provisions of the indenture, including restrictive covenants, to be amended by a majority of the debt issue.

[2] Registration Under the Trust Indenture Act.

As noted above, if new debt securities are issued, the indenture for such securities must be qualified under the Trust Indenture Act.ⁿ³ If a new security is deemed to be created by virtue of amendments to old debt securities through a consent solicitation, qualification of the supplemental indenture under the Trust Indenture Act may also be required.ⁿ⁴

If the debt securities are registered under the 1933 Act, the registration statement is filed together with the indenture as a required exhibit and a trustee's Form T-1. The indenture will be qualified at the time the registration statement is declared effective.

Neither a section 3(a)(9) nor a section 3(a)(10) exchange offer is exempt from qualification under the Trust Indenture Act.ⁿ⁵ An indenture for the new debt securities must be filed with the SEC on Form T-3.ⁿ⁶ The issuer may commence the exchange offer once the Form T-3 has been filed, and the indenture must be qualified by the time the exchange offer is completed.ⁿ⁷

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77ccc(1), (9). The Trust Indenture Act is not generally applicable to indentures governed

by foreign law.

(n2)Footnote 2. *15 U.S.C. § 77ppp(b)*. This right is unconditional and cannot be altered without the consent of the holder unless the indenture provides specifically that (i) less than all of the holders, but no less than three quarters in aggregate principal amount, may consent to a postponement of interest payments for up to three years or (ii) that a holder's right to institute suit may be limited if the institution of such a suit or the entry of a judgment thereon would, under applicable law, adversely affect any lien granted under the indenture. *15 U.S.C. § 77ppp(b)*.

(n3)Footnote 3. *15 U.S.C. § 77ccc(1), (9)*.

(n4)Footnote 4. *See P 5.12[4] infra*.

(n5)Footnote 5. *See 15 U.S.C. § 77ddd(a)(4)(A)*.

(n6)Footnote 6. *17 C.F.R. § 269.3*. Form T-3 requires information about the issuer, its capitalization, its management and the new securities. *Fed. Sec. L. Rep. (CCH) PP 43,141-45, at 33,141-45*. Form T-3 also requires that each offering document or other written communication sent to security holders be filed as an exhibit to Form T-3. *Id.*

(n7)Footnote 7. Mississippi Chemical Corp., SEC No-Action Letter [1989-1990 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 79,311* (June 23, 1989).



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P 5.10 Miscellaneous.

[1] State Blue Sky Laws.

In addition to compliance with the federal securities laws, the issuer must comply with state securities or "blue sky" laws applicable to an exchange offer. Two types of exemptions from state securities registration and offering material filing requirements are available in most states. A "transactional exemption" applies to any offer or sale of a security to existing security holders of the issuer or to an institutional investor. A "securities exemption" applies to any offer or sale of a security listed on the New York or American Stock Exchange or designated as a National Market System Security by the National Association of Securities Dealers Automated Quotation System ("NASDAQ") or of a security that is senior to such a listed or designated security.ⁿ¹

Under most "blue sky" laws, an issuer is excluded from the definition of "broker-dealer" and an issuer's agents are not required to register as such in connection with a transactional exemption.ⁿ² However, if registration of securities is required or if only a securities exemption is available, issuer dealer or agent registration could be required in a limited number of states, absent an arrangement with a registered dealer, to disseminate offering materials in such state.

[2] NASD Rules.

If a member of the National Association of Securities Dealers ("NASD") is involved in an exchange offer and there is a public distribution of securities, the NASD rules will apply to the exchange offer.ⁿ³ Participation by a NASD member includes acting as a financial advisor to the issuer in a section 3(a)(9) transaction. Section 4(2) offerings and Regulation D offerings are exempt from the NASD rules. Any compensation paid to an advisor is subject to the NASD guidelines.

FOOTNOTES:

(n1)Footnote 1. *See generally* Uniform Securities Act, § 402, Blue Sky L. Rep. (CCH) P 5542, at 1557 (1984).

(n2)Footnote 2. *See generally* Uniform Securities Act, § 401(c), Blue Sky L. Rep. (CCH) P 5541, at 1550 (1984).

(n3)Footnote 3. *See generally* H. Bloomenthal, *Going Public and the Public Corporation* §§ 12.84-85 (West 2007).



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P 5.11 Tender Offer Rules: Sections 14(e); 13(e)(4); 13(e)(3).

[1] Application.

[a] Exchange Offers.

Because an exchange offer involves the purchase of the issuer's currently outstanding old securities, such a transaction may be subject to the tender offer rules of the 1934 Act. Such rules are applicable if the exchange offer constitutes a "tender offer"; that term, however, is not defined in the 1934 Act nor in any rules promulgated thereunder. As a result, certain judicially-created tests are commonly cited to determine whether an offer to purchase securities constitutes a tender offer. Many courts have applied an eight-part test, often referred to as the "Wellman test," in order to determine whether a particular transaction constitutes a tender offer. The District Court of the Southern District of New York in *Wellman v. Dickinson*ⁿ¹ applied this analysis to determine whether a particular transaction constituted a tender offer. This test examines whether the transaction: (1) involved an active and widespread solicitation of security holders; (2) involved a solicitation for a substantial percentage of the securities (3) offered a premium over the market price; (4) contained terms that were fixed, rather than negotiable; (5) was conditioned upon the tender of a specified percentage of securities; (6) remained open for a limited period of time; (7) involved any pressure to influence security holders to respond to the offer; and (8) included public announcement preceding of accompanying the acquisition of a substantial amount of securities.ⁿ² Not all factors need to be present for a transaction to constitute a tender offer.ⁿ³ Although an exchange offer may include some of these factors, it is not clear that all exchange offers constitute tender offers. However, the common practice in exchange offers for public securities is to assume that the tender offer rules do apply.ⁿ⁴

The tender offer rules are comprised of three different statutory sections: section 13(e) and, in particular, Rules 13e-3 and Rule 13e-4 promulgated thereunder, section 14(d)ⁿ⁵ and section 14(e).ⁿ⁶ The applicability of specific regulations will depend upon (i) the identity of the party conducting the offer, *i.e.*, the issuer, an affiliate or a third party; and (ii) the type of security that is the subject of the tender offer, including, in particular, whether it is an equity or debt security and whether it is registered under section 12 of the 1934 Act.ⁿ⁷ In an exchange offer, the disclosure requirements under the tender offer rules may be satisfied by incorporating by reference the relevant information from the registration statement or offering circular. Any additional filing requirements may be satisfied by the filing of the required schedule as a "wrap-around" to the registration statement or offering circular.

[b] Combined Exchange Offer and Consent Solicitation.

An issuer must be aware of the application of the tender offer rules as applied to a combined tender offer and consent solicitation. In particular, the staff of the SEC has indicated that when an issuer conditions the acceptance of the tendered security on the delivery of a consent, as is customary, the consent will also be subject to the tender offer rules.ⁿ⁸ Additionally, record dates that determine who may validly deliver the requested consent raise a different issue. According to the staff, when a tender offer and consent combination falls under Regulation 14D or Rule 13e-4, the issuer has only three options with regard to such record dates: the issuer must either (i) establish a procedure to accept after such record dates any consents that are given in connection with purchases of the security, (ii) fix such record dates as the expiration date of the offer, or (iii) set no record date at all, assuming none is required under applicable state law.ⁿ⁹ The withdrawal rights afforded holders of equity securities require that the holders be entitled to revoke their consents until the expiration of the offer.ⁿ¹⁰

[2] Section 14(e) of the 1934 Act.

Exchange offers that involve only the tender of debt securities are subject to the less burdensome requirements of Regulation 14E. Regulation 14E applies generally to all tender offers for debt or equity securities of any company (whether public or private) other than certain exempted securities (such as government obligations, interests in bank trust funds and interests in certain employee benefit plans). Regulation 14E was developed to provide minimal procedural requirements applicable to all tender offers; it does not require any specific filings with the SEC. These procedural protections include: (i) a twenty-day minimum offering period;ⁿ¹¹ (ii) a prompt payment rule whereby consideration must be paid or the subject securities returned promptly after termination or withdrawal of the offer;ⁿ¹² (iii) procedural requirements regarding extensions of the offer;ⁿ¹³ and (iv) disclosure by the issuer regarding its position with respect to the tender offer.ⁿ¹⁴

Issuer tender offers for cash or non-convertible debt securities may be exempted from the application of Rule 14e-1(a) and (b). The SEC has consistently granted no-action requests with respect to these types of offers. To qualify for the exemption, the tender offer must be for any and all of the outstanding securities of the class, conducted in a manner affording all of the existing security holders the opportunity to participate in the offer and must not be in response to any other tender offer for the issuer's securities. This exemption typically applies in a situation involving a cash tender offer when the offering price is set at a small premium over the market price and the issuer is seeking to refinance debt with a higher interest rate than the prevailing market rate.ⁿ¹⁵

Moreover, section 14, specifically Rule 14e-3, prohibits fraudulent, deceptive or manipulative acts in connection with a tender offer.ⁿ¹⁶

[3] Issuer Tender Offers: Section 13(e) of the 1934 Act and Rule 13e-4.

[a] Application.

In an exchange offer in which the issuer makes a tender offer for equity securities, and in which the issuer either has a class of equity securities registered under section 12 of the 1934 Act or is required to file periodic reports under section 15(d) of the 1934 Act, Rule 13e-4 applies.ⁿ¹⁷ Rule 13e-4 governs even if the class of equity security that is the subject of the tender offer is not registered under section 12. If Rule 13e-4 applies, an issuer will have to comply with the procedural and disclosure requirements of Rule 13e-4, in addition to those of Regulation 14E. Moreover, certain limitations will be placed on the ability of the issuer and any affiliate to purchase securities during the tender offer period.ⁿ¹⁸ In a registered exchange offer, however, the incremental disclosure requirements are minimal.

[b] Requirements.

[i] Disclosure Requirements.

The disclosure requirements of Rule 13e-4 require that the issuer must file, on or prior to the commencement of the tender offer, a Schedule TO with the SEC. In the exchange offer context, the Schedule TO may be "wrapped-around" the registration statement or offering circular. Schedule TO mandates disclosure relating to the terms and conditions of the tender offer (including the amount and kind of securities sought, the consideration offered and any financing sources); the purposes of the tender offer; information relating to the securities that are the subject of the exchange, the issuer (including, to the extent material, historical and pro forma financial information) and, if different, the offeror; and certain recent transactions and agreements, arrangements and understandings with respect to the issuer's securities and plans or proposals relating to the acquisition of additional securities, mergers and certain other major corporate transactions. The disclosure requirements may be satisfied by incorporating by reference any relevant information contained in the registration statement or offering circular. As a general matter, most, if not all, of the information required by the Schedule TO will already be included in the registration statement or offering circular.

The issuer must also report any material changes in information contained in Schedule TO by promptly filing an amendment with the SEC.ⁿ¹⁹ In addition, no later than ten business days after termination of the tender offer, the issuer must file an amendment setting forth, among other things, the results of the tender offer.ⁿ²⁰

In addition to filing Schedule TO with the SEC, the issuer must disseminate to its security holders specific information relating to the offer, including a fair and accurate summary of the issuer's responses to the items required by Schedule TO.ⁿ²¹ This information is generally incorporated into the registration statement or offering circular.

[ii] Procedural Requirements.

Rule 13e-4 provides additional procedural protections that are not required for a tender offer of non-convertible debt securities under Regulation 14E. In particular, it imposes the following requirements: (i) a 20-day minimum offering period;ⁿ²² (ii) withdrawal rights;ⁿ²³ (iii) proration rights that apply when the offer is oversubscribed;ⁿ²⁴ (iv) a requirement that the issuer pay all holders the highest price paid for any securities of the same class in the tender offer (the "best price rule");ⁿ²⁵ (v) a requirement that the offer be made to all security holders of a particular class (the "all holders rule");ⁿ²⁶ (vi) rules regarding prompt payment for the securities tendered;ⁿ²⁷ and (vii) rules regarding extensions of the offer and disclosure by the issuer of its position with respect to the offer which mirror those in Regulation 14E.ⁿ²⁸ Of the foregoing list, the additional protections afforded by Rule 13e-4 are withdrawal rights, proration rights, the best price rule and the all holders rule.

In an exchange offer, the issuer is required to communicate the offer by mailing the long-form publicationⁿ²⁹ to each security holder, including sufficient copies to nominees holding securities "in street name" for delivery to beneficial owners.ⁿ³⁰

In a registered exchange offer, the offer may not commence until the registration statement has been declared effective and a final prospectus/offer to purchase has been mailed to security holders. In an exempt exchange offer, the tender offer may commence as soon as the issuer mails the offering circular/offer to purchase to security holders.

[4] The Going Private Rule (Rule 13e-3).

[a] Application.

The going private rules that are incorporated in Rule 13e-3 under the 1934 Act apply to any tender offer for equity securities by or on behalf of the issuer or an affiliate if the purpose or reasonably likely effect of the offer is to cause the securities to be held of record by less than 300 persons,ⁿ³¹ to be delisted from a national securities exchange or to be ineligible for quotation on an automated quotation system such as NASDAQ.ⁿ³² If an exchange offer is deemed to be a going private transaction, an issuer is required to comply with the additional procedural and disclosure requirements of Rule 13e-3 which, in the case of an exchange offer, will require certain additional disclosure mandated by Items 7, 8

and 9 of Schedule 13e-3.ⁿ³³

For practical purposes, the issuer may be able to avoid the application of this rule if it imposes a condition on the tender offer that it will not have the effect specified in Rule 13e-3, namely, causing the securities to be held of record by less than 300 persons, to be delisted from a national securities exchange or to be ineligible for quotation on an automated quotation system such as NASDAQ.

Rule 13e-3 does not apply to an exchange in which the new security is an equity security, provided that:

- (i) the new security has substantially the same rights as the old security, including, but not limited to, voting, dividends, redemption and liquidation rights, except that this requirement shall be deemed to be satisfied if unaffiliated security holders are offered common stock;ⁿ³⁴
- (ii) the new security is registered pursuant to section 12 of the 1934 Act or reports are required to be filed by the issuer thereof pursuant to section 15(d) of the 1934 Act;ⁿ³⁵ and
- (iii) if the old security was either listed on a national securities exchange or authorized to be quoted in an inter dealer quotation system of a registered national securities association, *i.e.*, NASDAQ, then the new security is either so listed or so authorized to be quoted.ⁿ³⁶

If the new security is not common stock, the availability of this exception depends upon what constitutes "substantially the same rights" under clause (i) above. The SEC has stated that exchange offers in which security holders are "permitted to maintain an equivalent or enhanced equity interest" are outside the general scope of Rule 13e-3.ⁿ³⁷ The SEC has granted no-action relief in situations involving (i) new convertible preferred stock exchanged for old senior subordinated notes, old debentures and old convertible preferred stock;ⁿ³⁸ and (ii) new convertible subordinated debentures exchanged for convertible depositary preferred shares.ⁿ³⁹

The SEC has, however, refused to take a no-action position in a situation in which convertible preferred stock (that was presently convertible) was exchanged for a new series of convertible preferred stock that was not immediately convertible.ⁿ⁴⁰ Differences in mandatory and optional redemption rights, dividend rates, acceleration rights and liquidation values will not necessarily render this exception unavailable. There is, however, little guidance as to how different the terms of the securities may be.

Moreover, in order to fall within the exemption, the new security must satisfy all three requirements. In this context, the SEC has rejected a no-action request when the new security was immediately convertible into the issuer's common stock, but was neither registered under section 12 nor subject to the reporting requirements of section 15(d) of the 1934 Act.ⁿ⁴¹ The SEC concluded that the exemption was unavailable despite the fact that the new security was convertible into common stock that was registered under section 12 of the 1934 Act because the new security itself did not satisfy the latter two requirements of the exemption. Thus, as a precaution, consummation of the exchange offer should be conditioned upon the satisfaction of these requirements.

[b] Requirements.

The issuer must file a Schedule 13E-3 with the SEC concurrently with the filing of preliminary proxy materials or concurrently with the filing of a registration statement under the 1933 Act. The issuer may satisfy the filing and disclosure requirements of Schedule 13E-3 by filing this schedule as a "wrap-around" to the registration statement or offering circular. The disclosure requirements in a going private transaction are very similar to those required by Schedule TO.ⁿ⁴² Rule 13e-3 mandates disclosure to security holders of a fair and accurate summary of most of the issuer's responses to the items required by Schedule 13E-3.ⁿ⁴³

In particular, the disclosure required by Schedule 13E-3 that is not otherwise required by Schedule TO or by Form S-4

includes:

- a statement of the purpose and effects of the transaction, an analysis of the alternatives and the reasons for the form of transaction chosen;ⁿ⁴⁴
- a statement as to whether the issuer or affiliate reasonably believes that the transaction is fair to security holders including a discussion of the material factors (and the weight given to each such factor);ⁿ⁴⁵ and
- a summary of any report, opinion or appraisal from a third party materially relating to the transaction (copies of which must be filed with the SEC and made available to security holders).ⁿ⁴⁶

As previously noted, these additional disclosure requirements may be onerous in a restructuring context.ⁿ⁴⁷

FOOTNOTES:

(n1)Footnote 1. *Wellman v. Dickinson*, 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979) , *aff'd on other grounds*, 682 F.2d 355 (2d Cir. 1982) , *cert. denied, sub nom. Dickinson v. SEC*, 460 U.S. 1069, 103 S. Ct. 1522, 75 L. Ed. 2d 946 (1983) ; *see also SEC v. Carter Hawley Hale Stores, Inc.*, 760 F.2d 945, 949-52 (9th Cir. 1985) (applying eight-part *Wellman* test). *But see Hanson Trust PLC v. SCM Corp.*, 774 F.2d 47, 57 (2d Cir. 1985) (rejecting eight-part test; relevant test is whether security holders require the protection of the tender offer rules), *rev'd on other grounds*, 781 F.2d 264, 1986 U.S. App. LEXIS 26714 (2d Cir. 1986) ; *S-G Sec., Inv. v. Fuqua Inv. Co.*, 466 F.Supp. 1114, 1126-27 (D.Mass. 1978) (establishing a two-prong test that looks for a public declaration of an intention to purchase a controlling share of the target company's stock, and a "subsequent rapid acquisition" of that stock); *Gorman v. Coogan*, 2004 WL 60271, *18-20 (D. Me. Jan. 13, 2004) (applying both the *Wellman* and the *S-G Securities* tests to reach the same outcome); *Pin v. Texaco, Inc.* 793 F.2d 1448, 1453-54 (5th Cir. 1986) (comparing the requirements of the *Wellman*, *Hanson Trust*, and *S-G Securities* tests and reaching the same result). *See* 1934 Act Release No. 16385, [1979-1980 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 82,374, at 82,601-06 (Nov. 29, 1979) for a proposed definition of tender offer that has never been officially adopted by the SEC.

(n2)Footnote 2. *Wellman*, n.1 *supra*, 475 F. Supp. at 823-24 .

(n3)Footnote 3. *See Wellman*, n. 1 *supra*, 475 F. Supp. at 824; *Carter Hawley Hale Stores Inc.*, n. 1 *supra* 760 F. 2d at 950 .

(n4)Footnote 4. The staff of the SEC has suggested that an exchange offer may be a form of tender offer and may therefore have to comply with the applicable tender offer rules. The staff of the SEC has also suggested that an exchange offer may be considered a tender offer or statutory merger depending upon whether the subject company's security holders exercise "individual volition." *See* D. Sirignano & G. Corso, *Federal Securities Law Issues Arising in Distressed Debt Restructurings*, 748 PLI/Corp. 631 at n. 12 (Aug. 19-20, 1991) ["Sirignano & Corso"].

(n5)Footnote 5. Section 14(d) and Regulation 14D, which apply to tender offers for equity securities of a public company by third parties or by affiliates (including a tender offer by an affiliate for more than 5% of a class of an issuer's equity securities), will rarely apply in an exchange offer situation. The disclosure and procedural requirements of Regulation 14D mirror those of Regulation 13E-4 with minor exceptions. *See P 5.11[3] infra*.

(n6)Footnote 6. Other important rules to consider with respect to tender offers and issuer repurchases are Regulation M, 17 C.F.R. § 242.101 (restrictions on purchases or bids by persons interested in distribution); Rule 14e-5, 17 C.F.R. § 240.14e-5 (prohibition on purchases of equity securities by offeror other than pursuant to tender offer); 17 C.F.R. § 240.14e-3 (transactions based on material non-public information); Rule 14e-3, 17 C.F.R. § 240.14e-4 (short-tendering or hedged tendering by persons responding to a partial tender offer); Rule 17Ad-14, 17 C.F.R. § 240.17AD-14 (book-entry depository accounts); Rule 13e-1, 17 C.F.R. § 240.13e-1 (purchases of equity securities by

issuer during third-party tender offer); and Rule 10b-18, 17 C.F.R. § 240.10b-18 (safe harbor for purchases of common stock by issuer and others).

Any new securities with put rights issued in an exchange offer may require compliance with the tender offer rules and Regulation M, 17 C.F.R. § 242.101 upon exercise of such put rights. *See* Lewis Galoob Toys, Inc., SEC No-Action Letter, 1989 SEC No-Act LEXIS 982 (available Sept. 29, 1989).

(n7)Footnote 7. 15 U.S.C. § 78l. *See* P 5.12[7][a] *infra* for a description of section 12 of the 1934 Act.

(n8)Footnote 8. *See Sirignano & Corso*, n.3 *supra*, at *651-52 .

(n9)Footnote 9. *Id.*

(n10)Footnote 10. Rule 14d-7, 17 C.F.R. § 240.14d-7; Rule 13e-4(f)(2), 17 C.F.R. § 240.13e-4(f)(2).

(n11)Footnote 11. Rule 14e-1(a), (b), 17 C.F.R. § 240.14e-1(a), (b) (the minimum period an offer to tender securities must remain open is 20 business days from commencement of tender offer; if notice is given regarding a change in the percentage of securities being sought (other than an increase not exceeding 2% of the outstanding securities), the consideration offered or the dealer-manager's soliciting fee, the minimum period the offer must remain open is 10 business days after such notice); *see also* 1934 Act Release No. 23421 [1986-1987 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 84,016*, at 88,196 n.70 (July 11, 1986) (following a material change in the terms or information of the offer, other than a change in price or percentage of securities sought, offer must remain open a minimum of five business days from date material change is first disseminated to security holders).

(n12)Footnote 12. Rule 14e-1(c), 17 C.F.R. § 240.14e-1(c).

(n13)Footnote 13. Rule 14e-1(d), 17 C.F.R. § 240.14e-1(d) (extensions of the offer must be made by press release or public announcement, including approximate amount of securities tendered, by 9:00 a.m. Eastern time (or the first opening of any stock exchange on which the security is listed, if earlier) on the next business day after the scheduled expiration date).

(n14)Footnote 14. Rule 14e-2, 17 C.F.R. § 240.14e-2 (the issuer must disclose its position with respect to the offer and its reasons for taking such position not later than ten business days after commencement of tender offer).

(n15)Footnote 15. *See, e.g.,* Salomon Brothers, Inc., SEC No-Action Letter, [1990-1991 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 79,643* (available Oct. 1, 1990).

(n16)Footnote 16. Rule 14e-3, 17 C.F.R. § 240.14e-3.

(n17)Footnote 17. Rule 13e-4, 17 C.F.R. § 240.13e-4, rather than Regulation 14D (which otherwise governs tender offers by affiliates) will apply to a tender offer by an affiliate for equity securities of the issuer if the issuer is required to file periodic reports under section 15(d) of the 1934 Act. Rule 13e-4 does *not* apply to, among other things, redemptions of securities that are pursuant to the terms of the applicable instrument, tender offers subject to section 14(d), odd-lot tender offers (except for the all holders and best price rules) and rescission offers.

(n18)Footnote 18. *See* Rule 13e-4(f)(6), 17 C.F.R. § 240.13e-4(f)(6) (prohibits certain purchases by the issuer or affiliate until ten days after termination of tender offer); Regulation M, 17 C.F.R. § 242.101 (prohibits certain persons, including the issuer and any underwriter, from bidding for or purchasing securities that are the subject of a distribution, until after such person has completed its participation in the distribution); Rule 14e-5, 17 C.F.R. § 240.14e-5 (prohibits persons making tender offers or exchange offers from purchasing securities of a company that is the subject of a tender offer or exchange offer other than pursuant to the tender offer or exchange offer from the time of the public announcement to the expiration of the offering period). *See generally* Lowenfels, Rule 10b-13, Rule 10b-6 and Purchase

of Target Company Securities During an Exchange Offer, 69 *Colum. L. Rev.* 1392 (1969).

(n19)Footnote 19. Rule 13e-4(c)(3), 17 *C.F.R.* § 240.13e-4(c)(3).

(n20)Footnote 20. See Schedule TO, 17 *C.F.R.* § 240.14d-100; 17 *C.F.R.* § 240.13e-4(c)(4).

(n21)Footnote 21. Rule 13e-4(d), 17 *C.F.R.* § 240.13e-4(d).

(n22)Footnote 22. Rule 13e-4(f)(1), 17 *C.F.R.* § 240.13e-4(f)(1) (the offer must remain open for 20 business days from commencement of tender offer and 10 business days after any notice of change in percentage of securities sought (other than an increase not exceeding 2% of the outstanding securities), the consideration offered or the dealer-manager's soliciting fee).

(n23)Footnote 23. Rule 13e-4(f)(2), 17 *C.F.R.* § 240.13e-4(f)(2) (holders have withdrawal rights for period during which offer remains open and if the tendered securities are not yet accepted for payment after the expiration of 40 business days after commencement of the tender offer).

(n24)Footnote 24. Rule 13e-4(f)(3), 17 *C.F.R.* § 240.13e-4(f)(3) (proration is required for the entire period during which the offer remains open; exceptions if tender offer so provides: (i) holders of less than 100 shares who tender all shares and (ii) conditional tenders; it should be noted that proration only arises in a partial tender offer and is therefore not generally applicable to exchange offers in the troubled company context (although in *Seaman* (see P 5.08[1][c][iii] *supra*) the exchange offer was for 90% of outstanding equity securities of a class)).

(n25)Footnote 25. Rules 13e-4(f)(8)(ii) and 13e-4(f)(10), 17 *C.F.R.* §§ 240.13e-4f(8)(ii) & 240.13e-4(f)(10) (all holders must receive the same price; consideration paid to any security holder must be the highest paid to any other security holder during such offer). Rule 13e-4(f)(8) does not prohibit offering more than one type of consideration, provided that security holders are afforded an equal right to elect among each of the types of consideration offered and the highest consideration of each type paid to any security holder is paid to any other security holder receiving that type of consideration.

(n26)Footnote 26. Rule 13e-4(f)(8)(i), 17 *C.F.R.* § 240.13e-4(f)(8)(i) (the offer must be open to all security holders of the class tendered).

The staff of the SEC has suggested that the all holders rule prohibits an issuer from excluding shareholders that are not accredited or sophisticated investors in a section 4(2) exchange offer that is also subject to the tender offer rules. See *Sirignano & Corso*, n.3 *supra*, at 650.

(n27)Footnote 27. Rule 13e-4(f)(5), 17 *C.F.R.* § 240.13e-4(f)(5) (consideration must be paid for the securities tendered or the securities must be returned promptly after the termination or withdrawal of the tender offer).

(n28)Footnote 28. See P 5.11[2], ns.12 & 13 *supra*.

(n29)Footnote 29. Rule 13e-4(e), 17 *C.F.R.* § 240.13e-4(e) (adequate publication in a newspaper on the commencement date of information that would typically be disclosed in the offer to purchase).

(n30)Footnote 30. Rule 13e-4(e), 17 *C.F.R.* § 240-13e-4(e).

(n31)Footnote 31. For purposes of determining whether an issuer is subject to the provisions of sections 12(g) and 15(d) of the 1934 Act, Rule 12g5-1 of the 1934 Act sets forth a definition of holders "of record." Rule 12g5-1, 17 *C.F.R.* § 240.12g5-1. Subject to certain qualifications, security holders who are identified on the records of the issuer are treated as holders "of record." Therefore, if a substantial percentage of securities is held "in street name," an issuer may find that it may not be subject to the going private rules because beneficial owners have become record holders, thereby

resulting in more than 300 record holders. Alternatively, an issuer may find that it is subject to the going private rules because the number of record holders falls below 300.

(n32)Footnote 32. If a partial tender offer is commenced by the issuer, the issuer must assume that the maximum amount of securities being sought by the issuer will be purchased.

(n33)Footnote 33. See Items 7-9 of Schedule 13E-3, 17 C.F.R. § 240.13e-100 Items 7-9.

(n34)Footnote 34. Rule 13e-3(g)(2)(i), 17 C.F.R. § 240.13e-3(g)(2)(i).

(n35)Footnote 35. Rule 13e-3(g)(2)(ii), 17 C.F.R. § 240.13e-3(g)(2)(ii).

(n36)Footnote 36. Rule 13e-3(g)(2)(iii), 17 C.F.R. § 240.13e-3(g)(2)(iii).

(n37)Footnote 37. 1934 Act Release No. 16075 [1979 Transfer Binder] *Fed. Sec. L. Rep. (CCH) P 82,166* (Aug. 2, 1979).

(n38)Footnote 38. Savin Corp., SEC No-Action Letter, 1988 SEC No-Act LEXIS 937 (available June 28, 1988).

(n39)Footnote 39. First Pennsylvania Corp., SEC No-Action Letter, 1984 SEC No-Act LEXIS 2360 (available July 12, 1984).

(n40)Footnote 40. Damson Oil Corp., SEC No-Action Letter, 1984 SEC No-Act LEXIS 2179 (May 4, 1984).

(n41)Footnote 41. First Fidelity Sav. & Loan Ass'n, SEC No-Action Letter, 1984 SEC No-Act LEXIS 2658 (available Sept. 28, 1984).

(n42)Footnote 42. See P 5.11[3][b] *supra*.

(n43)Footnote 43. Rule 13e-3(e), 17 C.F.R. § 240.13e-3(e).

(n44)Footnote 44. Item 7 of Schedule 13E-3, 17 C.F.R. § 240.13e-100 Item 7.

(n45)Footnote 45. Item 8 of Schedule 13E-3, 17 C.F.R. § 240.13e-100 Item 8.

(n46)Footnote 46. Item 9 of Schedule 13E-3, 17 C.F.R. § 240.13e-100 Item 9.

(n47)Footnote 47. See P 5.07[2] *supra* for a discussion of related disclosure issues.



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Collier Business Workout Guide

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CHAPTER 5 Exchange Offers

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P 5.12 Consent Solicitations.

[1] Overview.

In a consent solicitation, the issuer seeks consents (or proxies) from its security holders with a view toward amending or waiving the application of certain provisions of the securities or the indentures relating to the securities. Security holders may also be asked to release the issuer and its affiliates from any claims in connection with a previous leveraged buyout or leveraged recapitalization. A consent solicitation may be utilized in conjunction with an exchange offer or an issuer may choose to utilize a consent solicitation by itself.

[2] Purpose and Effects.

Amendments or waivers may be necessary to permit the restructuring to be consummated; they may also be desirable because the issuer is not in compliance with certain covenants or because the issuer seeks to relax certain restrictive covenants. The issuer will not generally utilize this method to modify payment terms, such as principal amount, interest rate, maturity date, redemption and sinking fund requirements because most indentures and section 316(b) of the Trust Indenture Act¹ (in the case of an indenture qualified under such Act) provide that the amendment of payment terms requires unanimous consent.

Consent solicitations are typically coupled with exchange offers in order to encourage security holders to tender into the offer and are often referred to as "exit consents" in such context. Usually, the issuer will seek to strip most or all of the restrictive covenants in the old indenture. The receipt of a consent from a security holder is made a condition to a valid tender and the receipt of the requisite percentage of holders to effectuate such amendment or waiver will be made a condition to the exchange offer. The security holder will consent to the proposed amendments to the old debt securities contemporaneously with tendering its old securities into the exchange offer; hence, the name "exit consent." At times, the issuer will offer some additional consideration, whether in the form of cash or equity, for the receipt of the consent. Assuming that the requisite percentage of security holders is obtained to amend the old indenture, any non-tendering security holder will be left with a security that may have the original payment terms, but has been stripped of most or all covenant protections.²

Exit consents may be characterized as somewhat coercive because a security holder is faced with the choice of tendering its old securities or retaining its old securities without covenant protections.³

In addition, exit consents sought in connection with non-convertible debt tender offers have been criticized by institutional investors as being particularly coercive because certain of the procedural and substantive protections afforded holders of equity securities under Rule 13e-4 (and Regulation 14D), such as the all holders rule,ⁿ⁴ the best price rule,ⁿ⁵ proration rightsⁿ⁶ and withdrawal rights,ⁿ⁷ do not apply to non-convertible debt tender offers.ⁿ⁸ Therefore, issuers have employed various techniques that could be characterized as coercive in the case of a combined debt tender offer and consent solicitation that cannot be used in the case of an equity tender offer. In a combined equity tender offer and consent solicitation, withdrawal rights would apply to both the tendered securities and the consent. Therefore, the holder would be able to withdraw its tendered securities and the consent at any time prior to the expiration of the offer. However, because holders of debt securities do not have withdrawal rights unless the issuer so provides, issuers may specifically provide that withdrawal rights only apply to the tendered securities in a combined debt tender offer and consent solicitation. Therefore, a holder cannot revoke its consent even if it can withdraw the tendered securities.ⁿ⁹

Furthermore, because the best price rule is not applicable, issuers may pay holders different prices for their securities and because the all holders rule is also not applicable, issuers may treat holders differently and pay consenting debt holders for their consents.

[3] Types of Amendments and Voting Requirements.

[a] General Requirements and Limitations.

Any amendments to or waivers of the terms of an issuer's old securities must comply with the applicable provisions of the indenture, certificate of incorporation or other instrument that governs the terms of the security. The type of amendments or waivers sought will necessarily be limited by the requisite percentage of holders required to effectuate each amendment.

In the case of preferred stock or common stock, modifications to terms and related voting requirements will be governed by the terms of the certificate of incorporation or certificate of designations as well as by applicable state corporate law requirements. In contrast to debt securities, the terms of preferred stock and common stock, including payment terms, generally may be amended by less than unanimous consent and all holders (including non-consenting holders) will be bound by such amendments.

Assuming that amendments are permitted by the applicable indenture or instrument, a majority or two-thirds in outstanding principal amount of the securities will generally be required to: (i) relax or eliminate restrictive covenants, such as limitations on the incurrence of additional debt, compliance with financial ratios, limitations on the payment of dividends and other distributions to stockholders and affiliates, and negative pledge provisions; (ii) relax or eliminate events of default, including, in particular, cross-default and cross-acceleration provisions; and (iii) increase the requisite percentage of holders to accelerate the issue or to take certain actions under the indenture. Unlike the above listed changes, unanimous consent will usually be required to: (i) modify payment terms; (ii) reduce the percentage of securities required for any amendment or waiver of a provision requiring unanimous consent; (iii) modify subordination provisions; and (iv) permit the new securities to rank ahead of the old securities in right of payment or permit the new securities to be guaranteed and/or secured if the old securities contain anti-layering provisions.ⁿ¹⁰

The new securities will generally include redemption provisions and restrictive covenants that will permit the new securities to be refinanced prior to maturity, but will generally block refinancing of the old securities prior to the maturity of the new securities. In addition to seeking amendments to the old securities, the issuer may also seek a waiver of existing events of default and, when appropriate, a rescission of acceleration. Most indentures will not permit a waiver of any payment default that has not been cured; therefore, the issuer will have to cure all payment defaults before such a waiver or rescission may be obtained. These waivers may be necessary or advisable because other agreements or instruments may also contain cross-default or cross-acceleration provisions that would be triggered if the

defaults were not waived.

With respect to preferred stock, the issuer may also seek a waiver of accrued but unpaid dividends or other existing defaults. However, there is generally no corresponding requirement to cure payment defaults. In fact, section 242(a)(4) of the Delaware General Corporation Law specifically provides that a corporation may amend its certificate of incorporation so as to "cancel or otherwise affect the right of the holders of the shares of any class to receive dividends which have accrued but have not been declared."ⁿ¹¹

[b] Voting of Treasury Securities.

Most indentures and section 316 of the Trust Indenture Act do not permit the inclusion of votes of the issuer and its affiliates when determining whether the requisite percentage of holders to effectuate an amendment or waiver has been obtained.ⁿ¹² Securities held by the issuer and its affiliates are not considered "outstanding" for such purposes.

An analogous restriction is also applicable in the case of preferred and common stock and can generally be found in the issuer's certificate of incorporation and in applicable state corporate law. For example, section 160(c) of the Delaware General Corporation Law prohibits a corporation and its direct and indirect subsidiaries from voting its shares (except when such shares are held in a fiduciary capacity).ⁿ¹³

[4] Amendments Creating a New Security.

A consent solicitation seeking only an amendment to an indenture does not generally involve the offer or sale of a new security for purposes of the 1933 Act and the Trust Indenture Act and, therefore, does not require registration under the 1933 Act or qualification under the Trust Indenture Act.

If amendments are sufficiently material to significantly affect the rights of security holders, the old security, as amended, may be deemed to constitute the offer and issuance of a new security under section 2(1) and (3) of the 1933 Act and section 303(1) and (2) of the Trust Indenture Act, thereby requiring registration under the 1933 Act and qualification under the Trust Indenture Act, unless an exemption is available from either Act.ⁿ¹⁴ The fact that a new certificate is not being issued or that the name of the security is not changed does not affect this analysis.

The relevant inquiry for the issuer is whether the proposed amendments alter the economic or basic terms of the security, thereby increasing the investment risks and requiring a new investment decision on the part of the security holder.ⁿ¹⁵ If this is the case, the amended security will be considered a new security for purposes of the 1933 Act and the Trust Indenture Act. For example, the extension of the maturity date has been considered to result in the creation of a new security.ⁿ¹⁶ If the proposed amendments can be characterized as adjustments to or alterations of the contractual rights effectuated in the manner contemplated by the indenture, the amended security will not be considered a new security. For example, amendments to restrictive covenants have generally not been considered to result in the creation of a new security. The SEC has consistently taken no-action positions with respect to amendments to restrictive covenants coupled with increases in the interest rate of the old securities.ⁿ¹⁷ The staff of the SEC has indicated, however, that the scope and effect of amendments in recent restructurings "have tended to extend beyond the facts contained in earlier staff no-action letters."ⁿ¹⁸

If a new security is deemed to have been created, the issuer will need to consider the availability of an exemption from registration under the 1933 Act such as section 3(a)(9) or 4(2).ⁿ¹⁹ Absent an exemption from registration, the issuer would have to register the amended security.

Although the Trust Indenture Act incorporates by reference certain exemptions from registration under the 1933 Act, the exemptions under sections 3(a)(9) and 3(a)(10)ⁿ²⁰ are not incorporated in the Trust Indenture Act. Therefore, if an amendment is deemed to create a new security, the supplemental indenture effectuating the amendment would have to

be filed with the SEC and qualified under the Trust Indenture Act even if registration is not required pursuant to the 1933 Act.ⁿ²¹

[5] Mechanics of Consent Solicitations.

Consent solicitations coupled with exchange offers are generally structured so that the receipt of a consent is a condition to a valid tender by the holder and/or the receipt of the requisite percentage of consents to effectuate the amendment or waiver is a condition to the offeror's obligation to consummate the exchange offer. It has become common practice to provide that the supplemental indenture effectuating the amendments be executed as soon as the requisite consents have been delivered so that the consents cannot be revoked even if the tendered securities are withdrawn.ⁿ²² The supplemental indenture, however, becomes effective upon the satisfaction of certain conditions such as the acceptance by the offeror of the tendered securities and the receipt of requisite consents from creditor groups. The SEC has taken the position that in a combined equity tender offer and consent solicitation subject to Rule 13e-4, the holder should also have withdrawal rights with respect to its consent to the same extent such withdrawal rights apply to the tendered securities; otherwise the transaction would violate the holder's withdrawal rights under Rule 13e-4.ⁿ²³ The SEC's position with respect to a combined equity tender offer and consent solicitation is not applicable to a combined tender offer and consent solicitation with respect to non-convertible debt securities, because withdrawal rights in the case of tender offers for non-convertible debt securities are not required under Regulation 14E of the tender offer rules.ⁿ²⁴

Since securities held by the issuer and its affiliates are not entitled to be counted for purposes of determining whether the requisite percentage to effectuate an amendment or waiver has been obtained,ⁿ²⁵ this can present a timing problem in a combined tender offer and consent solicitation context if the securities have been tendered. Arguably, once the securities have been tendered and accepted for payment, the issuer owns the securities and the consent is therefore being obtained from the issuer and not from the holder. It must be clear that the holder, not the issuer, has agreed to the exit consents.ⁿ²⁶ One way of addressing this issue in the case of non-convertible debt securities is for the issuer to provide withdrawal rights, which are not otherwise required by Regulation 14E of the tender offer rules, until the requisite consents have been obtained and a supplemental indenture executed.

[6] Validity of Exit Consents.

Exit consents have been upheld under Delaware and New York law. However, bondholders have sought to challenge the validity of exit consents on the basis of various legal theories, none of which has been successful. To the extent that the proposed amendments are effectuated in accordance with the terms of the indenture or other instrument, it seems unlikely that a court will be willing to imply a contractual obligation such as a covenant of good faith and fair dealing, absent special circumstances.

[a] Implied Covenant of Good Faith and Fair Dealing.

It is well settled that the rights of a holder of debt securities (including convertible debt securities) are governed by the indenture and are contractual in nature.ⁿ²⁷ In certain limited situations, such as insolvency, a violation of statute or fraud in the inducement, Delaware courts have implied a covenant of good faith and fair dealing.ⁿ²⁸ However, to date, courts have held that exit consents do not violate such a duty.

The two Delaware cases addressing this issue are *Katz v. Oak Industries, Inc.*,ⁿ²⁹ and *Kass v. Eastern Airlines, Inc.* ⁿ³⁰ In *Katz*, a bondholder sought to enjoin the combined exchange offer and consent solicitation based on an alleged breach of fiduciary duty. It also claimed that the allegedly coercive nature of the exit consents breached the issuer's implied covenant of good faith and fair dealing. Applying New York law as required by the indenture, the court held that (i) the contractual provisions granting a stated percentage of bondholders the right to consent to modifications did not prevent the issuer from offering incentives for consents on the same terms to all bondholders;ⁿ³¹ and (ii) contractual provisions prohibiting the issuer from voting debt securities held in its treasury did not prevent the issuer from soliciting consents

from bondholders to amendments to the indenture concurrently with the transfer of their bonds to the issuer.ⁿ³²

The court in *Katz* also enunciated the general standard of the implied covenant of good faith and fair dealing under Delaware law: "[I]t is clear from what was expressly agreed upon that the parties who negotiated the express terms of the contract would have agreed to proscribe the act later complained of as a breach of the implied covenant of good faith--had they thought to negotiate with respect to that matter. If the answer is yes, then, in my opinion, a court is justified in concluding that such act constitutes a breach of the implied covenant of good faith."ⁿ³³

The Delaware Chancery Court in *Kass v. Eastern Airlines, Inc.* followed the reasoning of *Katz*, holding that Eastern's consent solicitation was not a breach of the implied contractual obligation of good faith and fair dealing because the same offer was made to all bondholders.ⁿ³⁴ In *Kass*, Eastern Airlines offered a choice of cash or ticket vouchers to the holders of its five classes of debt securities who consented to the amendment of certain financial covenants (at the holder's option). The amount of the payment was calculated on the basis of each holder's principal amount of securities. Bondholders that did not consent received no consideration. Certain bondholders sought to enjoin the proposed amendments to the indentures. They asserted, *inter alia*, that the payment of consideration only to consenting bondholders constituted a breach of Eastern's implied contractual obligation of good faith and fair dealing. The court rejected these bondholders' argument. However, in *dicta*, the court indicated that a payment that was only offered to a limited number of bondholders could be a breach of the implied covenant of good faith and fair dealing.ⁿ³⁵

[b] Prohibition Against Vote-Buying.

A general public policy against vote-buying has also served as a basis for attacks on consent solicitations that involve payments to holders of debt securities for consents. However, to date, these payments have not been held to constitute vote-buying in contravention of such public policy.

[i] New York.

Section 609(e) of the New York Business Corporation Law (the "NYBCL") prohibits vote-buying in the context of equity securities.ⁿ³⁶ This provision has not been held to be applicable to debt securities. In *Pisik v. BCI Holdings Corp.*,ⁿ³⁷ the plaintiff sought to enjoin a corporation's consent solicitation involving debt securities alleging that the solicitation violated an implied covenant of good faith and fair dealing and that payment for consents constituted vote-buying in contravention of section 609(e) of the NYBCL. The Supreme Court of New York County held that the consent solicitation did not violate an implied covenant of good faith and fair dealing, nor did it constitute vote-buying, because the public policy considerations underlying the prohibition against vote-buying are not applicable to debt securities by the contractual nature of the relationship.ⁿ³⁸ The court distinguished the creditor relationship from the shareholder relationship by the attendant fiduciary duties in the shareholder context.ⁿ³⁹

[ii] Delaware.

There is no comparable statutory provision under Delaware law. However, Delaware courts have held that under certain circumstances vote-buying in a stockholder context may be void or against public policy.ⁿ⁴⁰

The plaintiffs in *Kass* also asserted that the consent payments constituted vote-buying, which is void *per se* in the context of public elections. The court in *Kass* concluded that under Delaware law, vote-buying may be "void or against public policy" if the purpose of the arrangement is fraudulent or the disenfranchisement of other stockholders.ⁿ⁴¹ The court concluded that the arrangement was not fraudulent because the terms of the arrangement were disclosed in the offering documents and that there was no disenfranchisement purpose in Eastern's offer because "the offer [was] made publicly to all voters on the same terms" and each bondholder could freely choose whether or not to accept such offer.ⁿ⁴²

[7] Proxy Rules.

[a] Application.

A consent solicitation may be subject to the proxy rules of the 1934 Act. Regulations 14A and 14C are the applicable sections. The proxy rules apply to any "solicitation"ⁿ⁴³ of a proxy. For purposes of the proxy rules, the term "proxy" is broadly defined to include any "proxy, consent or authorization"ⁿ⁴⁴ and would therefore also include the solicitation of an acceptance to a prepackaged plan. Proxy rules apply to securities registered under section 12 of the 1934 Act which includes (i) equity securities (including convertible debt securities) held of record by 500 or more holders where the issuer has total assets in excess of \$10 million and (ii) equity and debt securities listed on a national securities exchange.ⁿ⁴⁵

The proxy rules, however, do not apply, among other things, to any solicitation involving the offer and sale of registered securities, provided such securities are not issued in a Rule 145(a) transactionⁿ⁴⁶ or made otherwise than on behalf of the issuer when the total number of persons solicited does not exceed ten.

The scope of the first exemption referred to in the paragraph above is unclear and there is no formal guidance from the SEC as to the scope of such exemption.ⁿ⁴⁷ However, it would appear to be applicable to most combined registered debt exchange offers and consent solicitations. If, however, amendments to preferred stock are sought, the transaction would be within the purview of Rule 145(a) and the proxy rules would, therefore, apply to the solicitation.

Most exchange offers in a restructuring context are not subject to the proxy rules: exchange offers generally involve debt securities that are not registered pursuant to section 12 of the 1934 Act, or debt securities that are exempt from the proxy rules because they involve the offer and sale of registered debt securities that are not issued in a Rule 145(a) transaction. If the proxy rules do apply, however, there are a number of additional disclosure and procedural requirements that must be satisfied.ⁿ⁴⁸

[b] Requirements.**[i] Filing and Dissemination Requirements.**

Proxy statements and other soliciting materials are subject to review by the SEC. Each person solicited must concurrently be furnished (unless previously furnished) with a written proxy statement satisfying the disclosure requirements of Schedule 14A, or, if the proxy statement is included in a registration statement, Form S-4 or Form F-4. In a registered exchange offer, the prospectus may also serve as the proxy statement. In the event that the proxy rules are applicable to a combined exchange offer and consent solicitation because preferred stock is being reclassified or because acceptances to a prepackaged bankruptcy plan are being solicited, the solicitation will be subject to Regulation 14A. This regulation requires, *inter alia*, that preliminary forms of proxy statement, proxy and any other soliciting materials furnished to security holders concurrently with the proxy statement be filed with the SEC at least ten days before dissemination to security holders.ⁿ⁴⁹ For practical purposes, this review period will not delay the transaction since the registration statement filed under the 1933 Act will also be subject to SEC review. The filing of revised materials does not recommence the ten-day period unless the revised materials contain revisions or new proposals that constitute a fundamental change in the proxy materials.ⁿ⁵⁰

Preliminary copies are afforded confidential treatment by the SEC. If the issuer uses a combined proxy statement/prospectus, it may avail itself of confidential treatment if it files the document as "preliminary proxy materials" under Rule 14a-6 of the proxy rules (and not as a registration statement under the 1933 Act) until the document has been reviewed and cleared by the SEC.

Oral solicitations or voting instructions do not have to be reduced to writing and filed in preliminary form with the SEC. However, personal solicitation materials must be filed with the SEC not later than the date any such material is first sent or given to the individual making the actual solicitation.ⁿ⁵¹ This includes all written instructions or other materials that

discuss, review or comment upon the merits of any matter to be acted upon by the security holder and that are furnished to persons making the solicitation, such as financial advisors or information agents.

Solicitation materials to be used prior to the delivery of a proxy statement must be filed with the SEC no later than the date such material is published, sent or given to any security holder.ⁿ⁵²

Definitive proxy statements, proxies and other soliciting materials must be filed with the SEC and with each national securities exchange on which any of the issuer's securities are listed when definitive proxy materials are first disseminated to security holders.ⁿ⁵³

In an attempt to ensure that beneficial owners receive proxy or other soliciting materials, the proxy rules impose upon an issuer the obligation to communicate with beneficial owners or to ensure that beneficial owners will receive such materials from the nominee holders. If the issuer knows that any of the securities being solicited are held of record by a nominee (*e.g.*, broker, dealer, trustee, bank, etc.), it must, twenty business days (or if impracticable, as many days before as is practicable) prior to (i) the record date for a special meeting or (ii) the earliest date on which the consents may be used to effect the corporate action (if consents are being solicited), inquire as to and timely provide the nominee with adequate quantities of the proxy and other soliciting materials.ⁿ⁵⁴ The nominee has an obligation under the proxy rules to forward these materials to the beneficial owners.ⁿ⁵⁵

If the issuer only needs to solicit some of its security holders (*i.e.*, when certain larger holders possess the requisite percentage of securities to effectuate the transaction), the consent solicitation would be subject to Regulation 14C rather than Regulation 14A. The issuer would have to file the preliminary information statement at least ten days prior to dissemination to security holdersⁿ⁵⁶ and must disseminate the information statement to the security holders at least twenty days prior to the date of the corporate action, *e.g.*, the filing of an amendment to the issuer's certificate of incorporation.ⁿ⁵⁷

[ii] Disclosure Requirements.

The proxy statement or combined proxy statement/prospectus must comply with the disclosure requirements of Schedule 14A. In general terms, an issuer must disclose any material information with respect to matters submitted for security holder action as well as any material information relating to such action.ⁿ⁵⁸ Statements made with respect to the solicitation will subject the issuer to liability for false or misleading statements and omissions.ⁿ⁵⁹ The proxy rules require that a security holder be given an opportunity to approve, disapprove or abstain with respect to each matter referred to in the form of proxy/consent and impose certain limitations on the scope of discretionary authority that may be conferred by the proxy/consent.ⁿ⁶⁰

In the case of a combined exchange offer and consent solicitation that is subject to the proxy rules, the disclosure required by Item 11 (Authorization or Issuance of Securities Otherwise Than for Exchange), Item 12 (Modification or Exchange of Securities) and Item 13 (Financial and Other Information) will have to be furnished. The disclosure requirements of Form S-4 under the 1933 Act are substantially similar to those prescribed by Schedule 14A, except that information relating to security ownership of officers and directors and principal security holders will also have to be furnished under Schedule 14A.

If the solicitation is subject to Regulation 14C rather than Regulation 14A, an information statement containing the requirements of Schedule 14C must be furnished to each security holder that was not solicited.ⁿ⁶¹ The disclosure requirements of Schedule 14C are substantially similar to the requirements of Schedule 14A, except for disclosure items relating to the persons making the solicitation and the revocability of proxies. Statements made with respect to the solicitation will also subject the issuer to liability for false or misleading statements and omissions.ⁿ⁶²

[iii] Other Requirements.

An issuer will need to review applicable corporate law for certain substantive requirements relating to the fixing of a record date,ⁿ⁶³ the authority to execute a proxy, the effective period of a proxy and the revocability of a proxy.

If amendments are sought to a security listed on a stock exchange or quoted on a registered automatic quotation system such as NASDAQ or if the issuer has other securities listed or quoted, the applicable rules of the stock exchange or automated quotation system on which such security is listed or quoted should also be consulted.ⁿ⁶⁴

FOOTNOTES:

(n1)Footnote 1. 15 U.S.C. § 77ppp(b).

(n2)Footnote 2. Certain eurobond issuances that have collective action clauses may not require an exit consent because if the requisite percentage of holders consent, all holders are bound.

(n3)Footnote 3. Coffee, *Coercive Debt Tender Offers*, N.Y.L.J., July 19, 1990, at 5 ["Coffee"].

(n4)Footnote 4. Rule 13e-4(f)(8)(i), 17 C.F.R. § 240.13e-4(f)(8)(i); Rule 14d-10(a)(1), 17 C.F.R. § 240.14d-10(a)(1); see P 5.11[3][b][ii] *supra*.

(n5)Footnote 5. Rule 13e-4(f)(8)(ii), 17 C.F.R. § 240.13e-4(f)(8)(ii); Rule 14d-10(a)(2), 17 C.F.R. § 240.14d-10(a)(2); see P 5.11[3][b][ii] *supra*.

(n6)Footnote 6. Rule 13e-4(f)(3), 17 C.F.R. § 240.13e-4(f)(3); Rule 14d-8, 17 C.F.R. § 14d-8; see P 5.11[3][b][ii] *supra*.

(n7)Footnote 7. Rule 13e-4(f)(2), 17 C.F.R. § 240.13e-4(f)(2); Rule 14d-7, 17 C.F.R. § 240.14d-7; see P 5.11[3][b][ii] *supra*.

(n8)Footnote 8. See P 5.11[2] *supra*, for a discussion of Regulation 14E of the tender offer rules as applied to exchange offers; see also P 5.11[1][b] *supra* for a discussion of the tender offer rules as applied to a combined exchange offer and consent solicitation.

(n9)Footnote 9. The staff has suggested that such a procedure is necessary to comply with the "all holders rule." See P 5.11[3][b][ii] n.25 *supra*. The staff of the SEC has also suggested that this procedure may violate the prompt payment requirement of Rule 14e-1(c) of the 1934 Act, which provides that either the securities must be promptly paid for or the securities must be returned so that holders are returned to their original positions. Applying this rule to the tendered consent, the SEC seems to take the position that the tendered consent must be revoked if the offer is terminated or withdrawn without acceptance of the securities. Rule 14e-1(c), 17 C.F.R. § 240.14e-1(c); see P 5.11[2] *infra*.

(n10)Footnote 10. Certain eurobond issuances may provide for varied voting thresholds and may also allow these types of changes to be made without unanimous consent if certain voting thresholds are met.

(n11)Footnote 11. Del. Code Ann. tit. 8, § 242(a)(4).

(n12)Footnote 12. 15 U.S.C. § 77ppp(a).

(n13)Footnote 13. Del. Code Ann. tit. 8, § 160(c).

(n14)Footnote 14. 15 U.S.C. §§ 77b(a)(1), (3); § 77ccc(1), (2).

(n15)Footnote 15. The staff of the SEC has indicated that it analyzes "whether the proposed amendments, either individually or in the aggregate, would materially affect the rights and obligations of the parties. For example, as part of its analysis, the staff considers whether security holders are being asked to waive temporarily a provision solely for the

purposes of facilitating a particular transaction and the effect of that temporary waiver on the rights and protections afforded security holders." D. Sirignano & G. Corso, *Federal Securities Law Issues Arising in Distressed Debt Restructurings* 748 PLI/Corp. 631, 655 (Aug. 19-20, 1991) (1991) ["Sirignano & Corso"].

(n16)Footnote 16. *See, e.g., SEC v. Associated Gas & Elec.*, 99 F.2d 795, 797 (2d Cir. 1938) (the extension of the maturity date for either one year or five years, at the holder's option, constituted the issuance and sale of a new security for purposes of section 6(a) of the Holding Company Act); *Allied-Carson Corp.*, SEC No-Action Letter, [1975-1976 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 80,434 (Feb. 12, 1976) (two-year extension of maturity date with increase in interest rate constitute issuance of a new security).

It has been suggested that another relevant factor is whether the proposed amendment can be characterized as beneficial or detrimental to holders. *See generally* Adee, *Creating a New Statutory Security*, Insights, April 1989, at 23. If the proposed amendment is beneficial to holders, a new security may not be deemed to be created. *See* *Browning Debenture Holders Comm. v. DASA Corp.*, [1975 Transfer Binder] *Fed. Sec. L. Rep. (CCH)* P 95,071, at 97,754 (S.D.N.Y. 1975) (reduction of conversion price did not create a new security). However, if the proposed amendment is detrimental to holders, a new security will be deemed to be created. *See, e.g., Allied-Carson Corp.*, *supra*; *SEC v. Associated Gas & Elec.* *supra*; *Ingenito v. Bermec Corp.*, 376 F. Supp. 1154, 1180-81 (S.D.N.Y. 1974) (extension of payment terms and additional waivers of defenses and estoppel provisions falls under the statute).

(n17)Footnote 17. *See, e.g., PLM Cos., Inc.*, SEC No-Action Letter, 1987 SEC No-Act LEXIS 2426 (Sept. 14, 1987); *Electronic Memories & Magnetics*, SEC No-Action Letter, 1984 SEC No-Act LEXIS 2735 (Nov. 15, 1984); *Wilson Foods Corp.*, SEC No-Action Letter, 1984 SEC No-Act LEXIS 2415 (Aug. 6, 1984).

(n18)Footnote 18. *See Sirignano & Corso*, n.15 *supra*, at 655 .

(n19)Footnote 19. *See P 5.08 supra* for a discussion of the legal requirements of sections 3(a)(9), 3(a)(10) and 4(2); 15 U.S.C. § 77ddd(a)(4)(A). Exemptions from registration under the 1933 Act contained in sections 3(a)(2) through (8) & (11) have been incorporated by reference into the Trust Indenture Act. *Id.*

(n20)Footnote 20. *Id.*

(n21)Footnote 21. *See P 5.09 supra* for a discussion of the registration requirements of the Trust Indenture Act.

(n22)Footnote 22. The staff of the SEC has recently suggested that if consents are irrevocably executed prior to the expiration date of the offer, such procedure would violate the prompt payment requirement of Rule 14e-1(c) because if the offer is terminated or withdrawn without acceptance of the securities, security holders must be returned to their original positions. This would mean that the tendered consent as well as the tendered securities would have to be returned to the holder. *See Sirignano & Corso*, n.15 *supra*, at 652 .

(n23)Footnote 23. *See P 5.11[1][b] supra* for a discussion of the application of tender offer rules to a combined tender offer and consent solicitation.

(n24)Footnote 24. *See P 5.11[2] supra* for a discussion of the requirements of Regulation 14E.

(n25)Footnote 25. *See P 5.12[3][a] supra* for a discussion of limitations on an issuer's ability to vote treasury securities.

(n26)Footnote 26. Exit consents have been challenged on the basis that such consents violate this prohibition. Since the receipt of the requisite percentage of consents is a condition to the offer itself, a plaintiff has argued that the effect of such a structure is to permit the issuer to "dictate" the vote on securities which it could not itself vote." *Katz v. Oak Industries, Inc.*, 508 A.2d 873, 881 (Del. Ch. 1986) . This argument, however, was rejected by the court in *Katz* because the court concluded that the consents were being obtained from those "with a financial interest to maximize the

return on their investment" and the "incentive to consent is equally available to all ... bondholders." *Id.* See also *Coffee*, n.3 *supra*.

(n27)Footnote 27. See *Official Comm. of Unsecured Creditors v. Fleet Retail Fin. Group (In re Hechinger Inv. Co. of Del., Inc.)*, 274 B.R. 71, 89 (D. Del. 2002) ; *Katz*, n.26 *supra*, 508 A.2d at 879 ; *Harff v. Kerkorian*, 324 A.2d 215, 222 (Del. Ch. 1974) , *aff'd in relevant part, rev'd in part*, 347 A.2d 133 (Del. 1975) .

(n28)Footnote 28. See *Simons v. Cogan*, 542 A.2d 785, 788 (Del. Ch. 1987) , *aff'd*, 549 A.2d 300 (Del. 1988) .

(n29)Footnote 29. *Katz*, n.26 *supra*.

(n30)Footnote 30. 1986 Del. Ch. LEXIS 486 (Del. Ch. Nov. 14, 1986) . A New York court has followed the reasoning of *Katz* and *Kass* by rejecting the plaintiff's argument that a cash payment to consenting debt holders violates an implied covenant of good faith and fair dealing. See *Pisik v. BCI Holdings Corp.*, No. 14593/87 slip op. (Sup. Ct., New York County June 25, 1987).

(n31)Footnote 31. *Katz*, n.26 *supra*, at 881 .

(n32)Footnote 32. *Id.*

(n33)Footnote 33. *Katz*, n.26 *supra*, at 880 (*citation omitted*).

(n34)Footnote 34. *Kass*, n.30 *supra*, at *12-16.

(n35)Footnote 35. *Kass*, n.30 *supra* , 1986 Del Ch. LEXIS 486 *Kass*, n.30 *supra*, 1986 Del. Ch. Lexis 486. But see *GPC XLI L.L.C. v. Loral Space & Communs. Consol. Litig. (In re Loral Space & Communs. Consol. Litig.)*, 2008 Del. Ch. LEXIS 136 (Del. Ch. Sept. 19, 2008) (holding that even when bondholders receive uneven payments for their consent, the issuer does not breach a duty of good faith when the parties clearly considered such a scenario while negotiating the terms of the indenture and the uneven payments to not violate those finalized terms).

(n36)Footnote 36. Section 609(e) of the NYBCL states that "A shareholder shall not sell his vote or issue a proxy to vote to any person for any sum of money or anything of value, except as authorized in this section and section 620 (Agreements as to voting; provision in certificate of incorporation as to control of directors)." *N.Y. Bus. Corp. Law § 609(e)*.

(n37)Footnote 37. See *Pisik*, n.30 *supra* , No. 14593/87 slip op. (Sup. Ct., New York County June 25, 1987).

(n38)Footnote 38. *Id.* at 3.

(n39)Footnote 39. *Id.*

(n40)Footnote 40. See, e.g., *Schreiber v. Carney*, 447 A.2d 17, 26 (Del. Ch. 1982) ; *Chew v. Inverness Mgmt. Corp.*, 352 A.2d 426, 430 (Del. Ch. 1976) ; *Hall v. John S. Isaacs & Sons Farms, Inc.*, 146 A.2d 602, 613 (Del. Ch. 1958) , *aff'd in relevant part, rev'd in part*, 39 Del. Ch. 244, 163 A.2d 288 (Del. 1960) ; *Hewlett v. Hewlett-Packard Co.*, 2002 Del. Ch. LEXIS 44 (Del. Ch. Apr. 8, 2002) ; *Portnoy v. Cryo-Cell Intern, Inc.*, 940 A. 2d. 43, 66-71 (Del. Ch. Jan. 15, 2008).

(n41)Footnote 41. *Kass*, n.30 *supra* , 1986 Del. Ch. LEXIS 486, at *11 (Del. Ch. Nov. 14, 1986).

(n42)Footnote 42. *Id.* at *12.

(n43)Footnote 43. A solicitation includes:

- (i) [a]ny request for a proxy whether or not accompanied by or included in a form of proxy;
- (ii) [a]ny request to execute or not to execute, or to revoke, a proxy; or
- (iii) [t]he furnishing of a form of proxy or other communication to security holders under circumstances reasonably calculated to result in the procurement, withholding or revocation of a proxy.

Rule 14a-1(l)(1), 17 C.F.R. § 240.14a-1(l)(1).

(n44)Footnote 44. Rule 14a-1(f), 17 C.F.R. § 240.14(a)(1)(f).

(n45)Footnote 45. See Rule 12g-1, 17 C.F.R. § 240.12g-1. ("An issuer shall be exempt from the requirement to register any class of equity securities pursuant to section 12(g)(1) if on the last day of its most recent fiscal year the issuer had total assets not exceeding \$10 million and, with respect to a foreign private issuer, such securities were not quoted in an automated inter-dealer quotation system.")

(n46)Footnote 46. A Rule 145(a) transaction includes a merger, consolidation or other business combination, certain transfer of assets for securities of another person, a reclassification (other than a stock split, reverse stock split or change in par value), including consent solicitations seeking amendments to the terms of preferred stock or common stock. 17 C.F.R. § 230.145(a).

(n47)Footnote 47. See, e.g., Standard Oil (Indiana), SEC No-Action Letter, 1981 SEC No-Act LEXIS 3322 (available Mar. 24, 1981).

(n48)Footnote 48. An issuer must review state law requirements which govern such substantive issues as the authority to execute a proxy, the effective period of a proxy and the revocability of proxies. See generally H. Henn & J. Alexander, *Laws of Corporations and Other Business Enterprises* 518-528 (West 3d ed. 1983). Additional procedural requirements will have to be satisfied if the securities are listed on a stock exchange or quoted on NASDAQ. See P 5.12[7][b][iii] *infra* for a brief discussion of other procedural requirements.

(n49)Footnote 49. Rule 14a-6, 17 C.F.R. § 240.14a-6.

(n50)Footnote 50. Note 1 to Rule 14a-6; 17 C.F.R. § 240.14a-6 n.1.

(n51)Footnote 51. Rule 14a-6(c), 17 C.F.R. § 240.14a-6(c).

(n52)Footnote 52. Rule 14a-12(b), 17 C.F.R. § 240.14a-12(b). Notwithstanding the requirement that each person solicited must concurrently be furnished with a written proxy statement (§ 240.14a-3(a)), a solicitation may be made before furnishing security holders with such a proxy statement if: (1) each written communication includes: (i) the identity of the participants in the solicitation and a description of their direct or indirect interests, by security holdings or otherwise, or a prominent legend in clear, plain language advising security holders where they can obtain that information; and (ii) a prominent legend in clear, plain language advising security holders to read the proxy statement when it is available because it contains important information. (The legend also must explain to investors that they can get the proxy statement, and any other relevant documents, for free at the Commission's web site and describe which documents are available free from the participants); and (2) a definitive proxy statement meeting the requirements of § 240.14a-3(a) is sent or given to security holders solicited in reliance on this section before or at the same time as the forms of proxy, consent or authorization are furnished to or requested from security holders. Rule 14a-12(a), 17 C.F.R. § 240.14a-12(a).

(n53)Footnote 53. Rule 14a-6(b), 17 C.F.R. § 240.14a-6(b).

(n54)Footnote 54. Rule 14a-13, 17 C.F.R. § 240.14a-13.

(n55)Footnote 55. Rule 14b-1, 17 C.F.R. § 240.14b-1; Rule 14b-2, 17 C.F.R. § 240.14b-2.

(n56)Footnote 56. Rule 14c-5, 17 C.F.R. § 240.14c-5.

(n57)Footnote 57. Rule 14c-2(b), 17 C.F.R. § 240.14c-2(b).

(n58)Footnote 58. See Note A to Schedule 14A, 17 C.F.R. § 240.14a-101.

(n59)Footnote 59. Rule 14a-9(a) provides that no solicitation shall be made containing any statement which, "at the time and in light of the circumstances under which it is made, is false or misleading with respect to any material fact, or which omits to state any material fact necessary in order to make the statements therein not false or misleading." Rule 14a-9(a), 17 C.F.R. § 240.14a-9(a). The note to Rule 14a-9 indicates that predictions as to specific future market values and claims made prior to a meeting regarding the results of a solicitation are examples of conduct that may be considered misleading within the meaning of Rule 14a-9. *Id.*

(n60)Footnote 60. See Rule 14a-4, 17 C.F.R. § 240.14a-4.

(n61)Footnote 61. See Schedule 14C, 17 C.F.R. § 240.14c-101.

(n62)Footnote 62. Rule 14c-6, 17 C.F.R. § 240.14c-6.

(n63)Footnote 63. If securities are held by a brokerage firm "in street name," the applicable procedural requirements of any clearing agency will also have to be reviewed. If a clearing agency such as Depository Trust Company ("DTC") is the actual record holder, the issuer will have to fix a record date so as to enable DTC to grant an omnibus proxy conferring voting authority upon the participants as of such record date.

(n64)Footnote 64. See, e.g., New York Stock Exchange Listed Company Manual available at <http://www.nyse.com>; American Stock Exchange Company Guide available at <http://www.wallstreet.cch.com/amex>; National Association of Securities Dealers Manual available at <http://finra.complinet.com/finra>.



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Collier Business Workout Guide

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CHAPTER 5 Exchange Offers

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P 5.13 Problems with Exchange Offers.

The principal defect of the traditional exchange offer as a means to restructure public debt is the ability of a relatively small number of holders to block a restructuring effort that has substantial creditor support. Several factors have exacerbated the holdout problem in recent years and it has become increasingly difficult for a restructuring company to succeed with an exchange offer. The exceptional leverage found in many troubled leveraged buy-outs and recapitalizations now in restructuring has required increased levels of bondholder participation to ensure economic viability. In addition to the holdout problem, exchange offers may expose parties to substantial tax liability.

[1] Holdouts.

Although most covenants in public debt securities may be amended or eliminated by some form of majority consent, the payment terms of untendered bonds cannot be altered in an exchange offer, regardless of the number of tendering holders.ⁿ¹ Accordingly, the holdout becomes a problem when the economic terms of public debt must be restructured. In workouts of highly leveraged transactions the economic burden of publicly held, high-yield "junk" bonds is often the focus of the restructuring effort, and the holdout looms large as economic viability may require levels of bondholder participation well in excess of 90%.

The possibility of "holding out" creates two disincentives to participation in an exchange offer. First, there is a distinct economic advantage to being a holdout in a successful restructuring; a general deleveraging enhances the value of any debt that remains. Second, bondholders that are otherwise willing to participate may be reluctant to make concessions to benefit non-tendering members of their group.ⁿ² Likewise, one creditor group may condition participation in a restructuring upon a high level of participation in other, especially junior, creditor groups. Concern about the level of participation by others, whether by individuals within the same group or by other groups, has a distinct psychological element that cannot be overlooked. This is the belief that all parties benefiting from a restructuring should make a contribution, or "share the pain." In addition, there is the very practical aspect of the viability and long-term success of a restructuring.

[2] The "LTV Risk."

Bondholder concerns about economic feasibility increased sharply with the publication of the well known decision in the chapter 11 case of The LTV Corporation ("LTV").ⁿ³ The rule stated in that decision, which has been reversed by the Second Circuit, had the effect of penalizing participants in a restructuring that subsequently fails. In the two years prior

to its reversal, this rule had a significant role in reshaping the approach to public debt restructurings.

The *LTV* decision turned on the concept of original issue discount, or "OID." Generally, OID is the excess of the stated redemption price of a debt instrument over its issue price, *i.e.*, the consideration paid to the obligor at issuance.ⁿ⁴ OID is treated as interest and is amortized over the life of the debt instrument.ⁿ⁵ Unamortized OID constitutes unmatured interest,ⁿ⁶ which is not allowable as a claim in bankruptcy.ⁿ⁷ In the *LTV* case, LTV had issued \$116,000,000 face amount of new notesⁿ⁸ in exchange for a like face amount of previously issued notes. Shortly after completion of this exchange, LTV commenced a chapter 11 case in which it sought to disallow as unmatured interest that portion of the claim on the new notes that represented unamortized OID. The indenture trustee for the new notes argued that, if OID is not an allowable claim, the amount of OID in respect of the new notes should be determined by reference to the consideration originally given for the old notes when purchased from LTV.

The bankruptcy court rejected this argument and found that, for bankruptcy law purposes, OID in respect of notes issued in an exchange transaction is to be determined by reference to the consideration given in that exchange, that is, the value at the time of the exchange of the old notes surrendered.ⁿ⁹

The effect of the *LTV* ruling, the so-called "*LTV* risk," can be seen in a simple example. In an exchange offer, an outstanding bond with a face amount of \$1,000 (which we will assume to have no unamortized OID) is exchanged for a new \$1,000 bond with a reduced interest rate. At the time of the exchange, the old \$1,000 bond has a market value of \$500 as a result of the issuer's troubled financial condition. A holdout in the exchange offer retains its old \$1,000 bond also, of course, having a market value of \$500 at the time of the exchange. Under the *LTV* rule, in a subsequent bankruptcy of the issuer, the exchanging bondholder has a claim of only \$500 (plus any amortized OID as of the filing),ⁿ¹⁰ while the holdout retains a claim for \$1,000.

At one time, many restructurings employing an exchange offer were intended as multi-stage processes. To encourage participation, restructuring plans focused on the near-term, providing for the minimum required concessions from creditors with the understanding that additional concessions would be considered as and when necessary in a subsequent exchange offer. The *LTV* ruling eliminated the possibility of such exchange offers implementing marginal restructuring plans on an incremental basis where the risk of subsequent bankruptcy was inherent. It became necessary for any serious restructuring proposal to be sufficiently far-reaching to minimize demonstrably the likelihood of a subsequent bankruptcy. However, the more significant concessions required by these proposals increased the reluctance of bondholders to participate when there was a possibility of holdouts.

The Court of Appeals for the Second Circuit reversed the *LTV* ruling. In its reversal, the court of appeals affirmed the bankruptcy court's determination that OID constitutes unmatured interest that is not allowable as a claim in bankruptcy. However, the court held that the issuance of new debt securities in exchange for an equal face amount of outstanding debt securities does not, for bankruptcy law purposes, generate new OID.ⁿ¹¹ This ruling substantially mitigates, but does not eliminate, the *LTV* risk. The court of appeals distinguished, and did not rule upon, a debt-for-debt exchange that results in a net reduction of the issuer's outstanding obligations and a debt-for-equity exchange, in which outstanding equity securities are exchanged for newly issued debt securities. An exchange resulting in an overall reduction of outstanding debt should not, for bankruptcy purposes, create new OID, but no court has addressed these facts.ⁿ¹² A debt-for-equity exchange, however, in which there is no prior debt obligation of the issuer, should properly be distinguished and continues to present a risk.ⁿ¹³

[3] "Coercive" Exchanges.

Given the concerns raised about possible holdoutsⁿ¹⁴, troubled companies may attempt to employ various strategies that may leave nonparticipating bondholders in a worse position due to their nonparticipation. One technique used is for the distressed company to issue, in exchange for the existing debt, debt that is contractually, effectively or structurally more senior to the existing debt. The bondholders that choose not to participate would risk receiving less recovery in a

bankruptcy as the new debt would have a higher priority than the existing debt. Another option distressed companies consider is combining an exchange offer with an exit consent, in which the tendering bondholders agree to waive or amend certain terms (not relating to payment) in the existing bond indenture. If such an exit consent is successful, the nonconsenting bondholders will continue to hold their existing bonds (with the payment terms intact), but without the protections provided by the covenants that have been stripped by the exit consent. This leaves the nonconsenting bondholders with a significantly less attractive investment. A third option distressed companies will consider (particularly when the company is looking at a possible payment default), is combining an exchange offer with a simultaneous solicitation for votes to a plan of reorganization to be implemented through a voluntary Chapter 11 bankruptcy filing by the distressed company. Often, holdouts will have greater incentives to participate due to the possible bankruptcy of the company, which is often more costly than an out-of-court restructuring and entail additional risks, including possible litigation.

Bondholders who believe their interests are being harmed by the tactics that a distressed company may employ may choose to challenge the "coercive" exchange offer in court. Bondholders brought such a legal challenge against Realogy Corporation in 2008, when Realogy offered new second-lien debt under the existing accordion feature of its senior credit facility in exchange for multiple classes of outstanding unsecured notes. Under the terms of the exchange offer, the holders of senior subordinated notes and senior cash notes had first and second priority, respectively, to tender, after which the senior toggle bondholders had a right to tender (giving them last priority). As a result, the holders of the toggle notes had significantly limited opportunities to participate in the exchange.ⁿ¹⁵ To block the exchange, a majority of the toggle bondholders sued, alleging that the exchange breached certain negative covenants in Realogy's bond indenture and credit agreement.ⁿ¹⁶ The central dispute in the case was whether Realogy could refinance its unsecured debt with secured debt under its existing credit agreement.ⁿ¹⁷ The court rejected Realogy's arguments and declared that Realogy's only viable option for continuing with the exchange would be to obtain consents from its creditors as required under its agreements.ⁿ¹⁸

In another case, in March 2009, Freescale Semiconductors, Inc. offered its junior bondholders \$1 billion in senior incremental term notes in exchange for over \$3 billion of subordinated debt. This offer allowed the junior bondholders to exchange their debt for debt that would be *pari passu* with the debt of Freescale's senior bondholders. Shortly after Freescale issued new term notes under the new facility, numerous senior bondholders brought suit, alleging, in part, that the exchange offer violated the senior bondholders' credit documents.ⁿ¹⁹ The senior bondholders demanded monetary damages, rescission, and equitable subordination, which, when combined, would, for practical purposes return Freescale's debt structure to its pre-exchange form.ⁿ²⁰ In an unusual move, the senior bondholders also listed the participating junior bondholders as defendants, under claims of tortious interference with contract and unjust enrichment.ⁿ²¹ The senior bondholders argued that the junior bondholders tortiously interfered with the credit agreement when they accepted the new debt even though Freescale had suffered a materially adverse change, and the exchange unjustly enriched the junior bondholders by replacing their nearly valueless loans with relatively stronger loans that they did not deserve.ⁿ²² The theories of investor liability proposed by the senior bondholders in Freescale will need to be monitored to determine whether there are implications for bondholders looking to participate in future exchange offers.

Given the possible increased risk of litigation in these types of exchanges, a distressed company considering such an exchange should carefully review its strategy and existing debt documents and be prepared for legal challenges not only from the parties to such debt documents but from other interested creditors as well.ⁿ²³

FOOTNOTES:

(n1)Footnote 1. See PP 5.06[2] and 5.09[1] *supra* .

(n2)Footnote 2. There are, of course, other reasons a bondholder may not wish to participate in an exchange offer. Principally, the consideration offered may be deemed inadequate, given the restructuring company's financial condition and the treatment in the restructuring of other parts of its capital structure. For a discussion of the defenses open to such

a bondholder against a prepackaged bankruptcy, which can eliminate the ability to hold out, *see P 6.09 infra*.

(n3)Footnote 3. *In re Chateaugay Corp.*, 22 C.B.C.2d 530, 109 B.R. 51 (Bankr. S.D.N.Y. 1990) , *aff'd*, 130 B.R. 403 (S.D.N.Y. 1991) , *aff'd in part and rev'd in relevant part*, 961 F.2d 378, 26 C.B.C.2d 1174 (2d Cir. 1992) ; *see also In re Pengo Indus., Inc.*, 129 B.R. 104 (N.D. Tex. 1991) (reversing an order of the bankruptcy court that the issuance by one of the debtors of new debentures in exchange for a like face amount of its outstanding debentures gave rise to original issue discount), *aff'd*, 962 F.2d 543, 27 C.B.C.2d 119 (5th Cir.) , *cert. denied*, 506 U.S. 1000, 113 S. Ct. 602, 121 L. Ed. 2d 538 (1992) .

(n4)Footnote 4. *See In re Chateaugay Corp.*, 961 F.2d 378, 380, 26 C.B.C.2d 1174, 1177 (2d Cir. 1992) .

(n5)Footnote 5. *In re Chateaugay Corp.*, 961 F.2d at 380, 26 C.B.C.2d at 1177 .

(n6)Footnote 6. *In re Chateaugay Corp.*, 961 F.2d at 381, 26 C.B.C.2d at 1178 .

(n7)Footnote 7. 11 U.S.C. § 502(b)(2); *In re Chateaugay Corp.*, 961 F.2d at 381, 26 C.B.C.2d at 1178 (citing cases).

(n8)Footnote 8. Shares of common stock were also issued in the exchange.

(n9)Footnote 9. The court did not address the effect on its analysis of the issuance of the shares of common stock as a part of the exchange. Presumably, some portion of the value of the old notes surrendered would be allocated to the shares of stock received, thereby reducing the consideration given for the new notes and increasing their OID.

(n10)Footnote 10. The lower court also determined that the amortization of OID should be calculated using the "constant interest" or "economic accrual" method, under which annual amortizations increase over time rather than the "straight line" method, under which amortizations are in equal annual installments. *In re Chateaugay Corp.*, n.3 *supra*, 22 C.B.C.2d at 539, 109 B.R. at 57 . The Court of Appeals for the Second Circuit affirmed the lower court's use of the constant interest method, holding that it "comports more closely than the straight line method with economic reality." *In re Chateaugay Corp.*, n.4 *supra*, 961 F.2d at 383, 26 C.B.C.2d at 1181 .

(n11)Footnote 11. *In re Chateaugay Corp.*, n.4 *supra*, 961 F.2d at 383, 26 C.B.C.2d at 1182 . The circuit court did note, however, that any OID in respect of the old debt exchanged that is unamortized at the time of exchange is carried over to the new debt received. The circuit court also affirmed the bankruptcy court's determination that amortization of OID should be calculated using the "constant interest" method. *Id.*

(n12)Footnote 12. *In re Pengo Indus., Inc.*, n. 3 *supra*, 129 B.R. 104 (N.D. Tex. 1991), in which the court determined that no new OID was created in an exchange, also involved a debt-for-debt exchange of equal face amounts.

(n13)Footnote 13. In *Brown v. Sayyah (In re I.C.H. Corp.)*, 230 B.R. 88 (N.D. Tex. 1999) , the court distinguished between the debt-for-debt exchanges and debt-for-equity transactions and declined to automatically extend the decisions of the Court of Appeals for the Second Circuit in *In re Chateaugay Corp.*, n.4 *supra* , 961 F.2d 378, 26 C.B.C.2d 1174 , and the Court of Appeals for the Fifth Circuit in *In re Pengo Indus., Inc.*, n.12 *supra* , 962 F.2d 543, 27 C.B.C.2d 119 , to the context of a debt-for-equity transaction in determining whether or not a new OID had been created by the debt-for-equity transaction. The *ICH Corp.* court also found the decision in *In re Allegheny Int'l, Inc.*, 23 C.B.C.2d 71, 100 B.R. 247 (Bankr. W.D. Pa. 1989) (where new OID had been generated by a debt-for-equity exchange) distinguishable on its facts. For example, the issuer in *In re Allegheny Int'l, Inc.* never disputed the existence of OID in the notes. Furthermore, since the notes were publicly traded, the value of the OID was easily determinable.

(n14)Footnote 14. *See Section 5.13[1]*.

(n15)Footnote 15. *See Bank of New York Mellon v. Realogy Corporation.*, No. 4200- VCL, 2008 Del. Ch. LEXIS

186, at *4-7 (Del. Ct. Ch. Dec. 18, 2008) .

(n16)Footnote 16. *See id.* at *11-13, *23-26.

(n17)Footnote 17. *See id.* at *23-31.

(n18)Footnote 18. *See. i d.* at *30

(n19)Footnote 19. *See* Complaint, ING Prime Rate Trust v. Freescale Semiconductor Inc., No. 09-600906 (N.Y. Sup. Ct. March 24, 2009).

(n20)Footnote 20. *See id.* at 22-27.

(n21)Footnote 21. *See id.* at 3.

(n22)Footnote 22. *See id.* at 24-26.

(n23)Footnote 23. *See* Bank of New York Mellon v. Realogy Corporation., No. 4200- VCL, 2008 Del. Ch. LEXIS 186, at *30 (Del. Ct. Ch. Dec. 18, 2008) (noting "the irony" in the plaintiff "enforc[ing] a document whose terms are not for the [plaintiff's] benefit" and whose terms could be amended by parties other than the plaintiff to allow the exchange.)



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CHAPTER 6 Prepackaged Bankruptcies

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P 6.01 Introduction.

Although an exchange offer is viable when a troubled company is not highly leveraged, it becomes more and more difficult to deleverage by means of a consensual exchange offer when the economics of recovery demand very high acceptance levels by holders of public debt. Because high acceptance levels provide enormous leverage to holdouts, other restructuring techniques were developed to supplement and even supplant the exchange offer. One such technique is the prepackaged chapter 11 plan, in which a troubled company solicits acceptances to a plan of reorganization prior to filing under chapter 11. Upon obtaining the requisite acceptances, the company files its presolicited plan in bankruptcy court, thereby taking advantage of the Bankruptcy Code provisions that permit the plan to bind dissenting holders of claims and interests. Although a prepackaged plan uses a bankruptcy filing to achieve a restructuring, both an out-of-court exchange offer and a prepackaged chapter 11 case share the same goal--allowing a company to reorganize without going through a lengthy chapter 11 case.

Before the emergence of prepackaged bankruptcy cases, the only alternative to an exchange offer for restructuring public debt was a lengthy bankruptcy. A prepackaged chapter 11 employs a case under chapter 11 of the Bankruptcy Code to implement a restructuring plan, referred to as a "prepackaged" plan.ⁿ¹ However, a prepackaged bankruptcy is closer to an out-of-court restructuring than it is to a "regular" chapter 11 case. As with an exchange offer, the prepackaged plan is based on an agreement reached in out-of-court negotiations. The chapter 11 case is not itself used to resolve intercreditor and debtor-creditor disputes, but only to put the prepackaged plan into effect. The plan and related chapter 11 case are called "prepackaged" because (ideally) all issues concerning the reorganization are resolved prior to commencement of the bankruptcy case, leaving only the procedural steps required to confirm the plan.

A prepackaged bankruptcy is an effective tool for dealing with holdouts. If a prepackaged plan is accepted by the requisite percentages of creditors and stockholders and certain other requirements of the Bankruptcy Code are satisfied,ⁿ² the plan will become binding on all parties, including parties that did not vote or voted against the plan. This eliminates any economic advantage to non-participation. In addition, the knowledge that a restructuring in a prepackaged bankruptcy will either affect all parties or will not occur may, in fact, encourage a higher degree of voluntary participation. This consideration, which made the type of far-reaching solution necessary to alleviate concerns about the LTV risk more acceptable to creditors, has contributed to the appeal of a prepackaged chapter 11 plan as a restructuring technique.ⁿ³ Parties who are involved in negotiating a pre-packaged plan also may enjoy the benefits of significant court-ordered release and exculpation protections, shielding their good faith efforts from possible legal challenges brought by non-consenting holdouts and encouraging creditor participation in the restructuring process.

Finally, prepackaged plans, because they are consummated in a chapter 11 case, have significant tax advantages over exchange offers in avoiding cancellation of indebtedness income and, in certain circumstances, preserving the ability to use pre-restructuring net operating losses.

FOOTNOTES:

(n1)Footnote 1. In addition, class actions under *Fed. R. Civ. P. 23* have been used as a substitute for an exchange offer which does not involve a bankruptcy proceeding. This procedure works as follows: a group of bondholders brings suit on their bonds (for payment following a monetary default and/or, perhaps, alleging securities law claims); the suit is established as a class action on behalf of all bondholders; and a negotiated restructuring of the bond obligations is then presented to the court as a settlement of the action. If approved by the court, and subject to the Federal Rules of Civil Procedure, the settlement will bind the entire class, *i.e.*, all bondholders, with no holdouts. This use of the class action raises a number of issues under the Federal Rules of Civil Procedure and applicable securities laws that remain to be tested in the courts. In addition, certain beneficial provisions of the Bankruptcy Code and the tax advantages of a restructuring in a chapter 11 case are not available. For a general discussion for this use of Rule 23 class actions, see R.L. Epling, *Are Rule 23 Class Actions a Viable Alternative to the Bankruptcy Code?* 23 *Seton Hall L. Rev.* 1555 (1993).

(n2)Footnote 2. See P 1.09 *supra* for a general discussion of Bankruptcy Code requirements relating to the formulation and confirmation of a plan of reorganization.

(n3)Footnote 3. See generally P 5.13[2] *supra* for a discussion of the LTV risk. It should be noted that nothing in the *LTV* opinion suggested that its holding would not apply to an exchange effected in a chapter 11 case. The LTV risk, to the extent it still exists, is reduced (but not necessarily eliminated) in a restructuring effected in a prepackaged bankruptcy to the extent that such a restructuring reduces the risk of a second bankruptcy subsequent to the prepackaged bankruptcy.



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P 6.02 What is a Prepackaged Plan?

[1] Overview.

A prepackaged plan is a plan of reorganization under chapter 11 of the Bankruptcy Code that is negotiated and agreed to by all necessary parties prior to the filing of the petition that commences the chapter 11 case in which it is put into effect. A prepackaged plan develops in much the same manner as an exchange offer: in out-of-court negotiations with representatives of affected creditor and stockholder groups.ⁿ¹ However, because it is implemented in a chapter 11 case, a prepackaged plan offers the advantage of the class vote, one of the most powerful restructuring tools under the Bankruptcy Code. While reorganization under chapter 11 is a consensual process, acceptance of a plan of reorganization is not based on consent by individuals but on consent by classes of creditors and stockholders. A specially defined majority in a given class can bind all members to a plan, with no holdouts.ⁿ² Moreover, in certain circumstances an entire dissenting class can be bound.ⁿ³

The chapter 11 case that follows once the necessary votes for a prepackaged plan have been received must comply with the requirements of the Bankruptcy Code. The contentious and time-consuming work of negotiating a plan of reorganization, however, will have already been completed out-of-court and the necessary consensus on the plan will have been reached. Neither creditors nor the company need rely on the chapter 11 case to resolve disputes. After completion of necessary procedural steps, including approval of the disclosure statement used in the prepetition solicitation of votes, official tabulation of votes received and determination of the feasibility of the plan, the prepackaged plan will be confirmed and become effective and binding on all parties.ⁿ⁴

This idealized sketch highlights the two fundamental advantages that distinguish a prepackaged chapter 11 from both an exchange offer and a regular chapter 11 case. First, an overall restructuring, with no holdouts, can be effected in a chapter 11 case with the consent of the requisite percentages of parties in the affected classes. Second, when the required consensus is achieved out-of-court, the related chapter 11 case can be speedierⁿ⁵ and less disruptive to the reorganizing company, principally by eliminating the time required to develop and negotiate a plan of reorganization, the need for the company and its creditors and stockholders to dispute various rights under the Bankruptcy Code, and the ability of other interested parties to propose a competing plan.ⁿ⁶

In an effort to bring procedural uniformity to prepackaged cases, the Bankruptcy Court of the Southern District of New York has adopted a standing General Order ("General Order 201")ⁿ⁷ which provides a broad set of guidelines for filing

prepackaged chapter 11 cases.

[2] Alternatives to "Full" Prepackaged Bankruptcy.

There are steps short of a "full" prepackaged chapter 11 case⁸ that, in correspondingly diminished degrees, may afford some of the benefits of a prepackaged case. The varying degrees of pre-filing preparation and agreement reflected in the following approaches may affect the duration, cost and degree of uncertainty in the related chapter 11 case.

[a] Pre-Negotiated/Pre-Arranged Chapter 11 Case.

Under a pre-negotiated/pre-arranged chapter 11 case, a plan of reorganization is negotiated among the parties prior to the filing, but no formal solicitation of votes occurs until after the filing of the chapter 11 petition. If a plan has been negotiated, but votes have not been solicited before a chapter 11 filing, the vote solicitation process can occur promptly after the chapter 11 petition has been filed and the bankruptcy court has approved a disclosure statement for distribution to creditors and shareholders. The disclosure statement and plan can be filed with the bankruptcy court immediately upon commencement of the chapter 11 case.⁹ However, solicitation cannot begin until the disclosure statement has been approved.¹⁰

Pre-negotiated/pre-arranged cases are appropriate when the parties wish to attract a minimum of public attention to a company's impending chapter 11 case. At least in theory, they can be negotiated in secret and only made public upon the filing and commencement of the chapter 11 case.¹¹ However, once the chapter 11 case has begun, a plan of reorganization must be worked out in detail, and a disclosure statement drafted and approved, before solicitation can commence.

There are some important considerations to bear in mind when deciding between a pre-negotiated/pre-arranged case and a full prepackaged case. Because the formal solicitation of votes in a pre-negotiated/pre-arranged case does not occur until after the chapter 11 case has commenced, there is the risk that the debtor will not receive the votes required for the plan. A chapter 11 case may also take longer to accomplish with a pre-negotiated/pre-arranged case because, again, the votes must be solicited post-petition.¹²

[b] Partial Prepackaged Chapter 11.

Under a partial prepackaged plan, the votes of certain classes on the prepackaged plan of reorganization are solicited before the filing of the petition that commences the chapter 11 case, while the votes of other classes are solicited after the filing and commencement of the chapter 11 case.¹³ The principal advantage to this sort of arrangement is obvious: partial prepackaged cases allow at least some streamlining in cases where fewer than all of the necessary votes can be marshaled before the petition date. The Bankruptcy Court of the Southern District of New York has expressly acknowledged the use of partial prepackaged plans in General Order 201.¹⁴

FOOTNOTES:

(n1)Footnote 1. See PP 5.04 and 5.05 *supra* .

(n2)Footnote 2. A plan is deemed to have been accepted by a class of creditors if it is accepted by class members that hold at least two-thirds in amount and more than one-half in number of the allowed claims held by those class members actually voting on the plan. 11 U.S.C. § 1126(c). A plan is deemed to have been accepted by a class of stockholders if it is accepted by class members that hold at least two-thirds in amount of the allowed interests held by those class members actually voting on the plan. 11 U.S.C. § 1126(d).

(n3)Footnote 3. See P 1.09[3][c] *supra* and P 6.08[3] *infra* for a discussion of the requirements of a cramdown of a dissenting class.

(n4)Footnote 4. See P 1.09[3] and [4] *supra*.

(n5)Footnote 5. The sale of assets under section 363 of the *Bankruptcy Code* is another method employed by debtors in an attempt to exit a chapter 11 case quickly. For a discussion of Section 363 sales, see P 7.[] *infra*. The advantage of a speedier chapter 11 case is particularly salient in an environment where credit is tight. For a discussion of DIP financing, see P 6.06[2] *infra*.

(n6)Footnote 6. The debtor has the exclusive right to file a chapter 11 plan of reorganization during the first 120 days after the petition date. 11 U.S.C. § 1121(b). This "exclusivity period" can be reduced or increased by the court for cause, 11 U.S.C. § 1121(d)(1), but is limited to a maximum of eighteen months. 11 U.S.C. § 1121(d)(2)(A), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). Once the exclusivity period has expired, any party in interest may file a plan of reorganization.

(n7)Footnote 7. In the Matter of Adoption of Prepackaged Chapter 11 Case Guidelines, General Order 203, Amending General Order 201 (Bankr. S.D.N.Y. February 24, 1999). A description of the General Order is set forth in section P 6.08[4] of this chapter. See also General Order 203, Southern District of New York, *reprinted in* Collier Bankruptcy Practice Guide Local Rules Pamphlet (Matthew Bender). For a detailed discussion of the General Order, see S. E. Mayerson, *Current Developments in Prepackaged Bankruptcy Plans*, 838 PLI/Comm 337 (No. A0-00E6 April 2002). The General Order was incorporated into the local procedural rules of the Southern District of New York, effective August 2, 2004.

(n8)Footnote 8. That is, one in which the plan of reorganization is fully negotiated and documented and the requisite votes are received prior to commencement of the chapter 11 case.

(n9)Footnote 9. A debtor may file a plan of reorganization together with its petition commencing a chapter 11 case. 11 U.S.C. § 1121(a).

(n10)Footnote 10. Disclosure materials used in postpetition solicitations require the prior approval of the bankruptcy court. 11 U.S.C. § 1125(b). Twenty-five days' notice to parties in interest is required for a postpetition hearing (and relevant objection deadline) to approve a disclosure statement. *Fed. R. Bankr. P. 2002(b)*.

In the case of a small business debtor, in addition to other options, the court may conditionally approve a disclosure statement subject to final approval after notice and a hearing, and acceptances and rejections of a plan may be solicited based on a conditionally approved disclosure statement as long as the debtor provides adequate information to each holder of a claim or interest that is solicited. 11 U.S.C. § 1125(f), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n11)Footnote 11. See Susan M. Freeman, *The Acquisition of Troubled Companies*, American Law Institute--American Bar Association, Continuing Legal Education 507 at 519 (March 5, 1998).

(n12)Footnote 12. See, D.S. Bernstein, *Practical Guide to Acquiring the Troubled Company*, American Law Institute--American Bar Association Continuing Legal Education 317, 377-378.

(n13)Footnote 13. The 1991 amendment of *Fed. R. Bankr. P. 3018(b)* makes possible a bifurcated solicitation of this sort. Prior to this amendment, the rule invalidated any votes received prepetition unless substantially all parties in all impaired classes were solicited. Under the amended rule, votes received from any class will be valid if substantially all parties in that class were solicited, sufficient time was given to vote on the plan and the debtor otherwise complied with the provisions of section 1126(b) (discussed *infra* P 6.03[1] and P 6.07). *Fed. R. Bankr. P. 3018(b)*.

(n14)Footnote 14. See P 6.08[4] *infra* (discussing General Order 201).



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P 6.03 Statutory Basis of a Prepackaged Chapter 11 Case.

Prepackaged chapter 11 cases are possible because the Bankruptcy Code provides that votes received prior to the commencement of a chapter 11 case may be used to confirm a plan of reorganization. In addition, other provisions of the Bankruptcy Code may be used to expedite that case once it has been commenced.

[1] *Bankruptcy Code Section 1126(b).*

Section 1126(b) of the Bankruptcy Code provides that a plan of reorganization can be confirmed using acceptances solicited and received prior to the commencement of the case.ⁿ¹ However, the vote must have been solicited with adequate disclosure. Adequacy of disclosure is determined under applicable nonbankruptcy law or if there is no such applicable law, in accordance with the concept of "adequate information" defined in *section 1125(a) of the Bankruptcy Code*.ⁿ² Accordingly, careful attention must be given to the preparation of the disclosure statement used in the prepetition solicitation.

[2] *Federal Rule of Bankruptcy Procedure 3018(b).*

Federal Rule of Bankruptcy Procedure 3018(b) sets forth the minimum procedural requirements for prepetition solicitations.ⁿ³ The prepetition vote of a creditor or stockholder will not be valid if the bankruptcy court determines, after notice and hearing, that the prepackaged plan and disclosure statement were not transmitted to substantially all creditors or stockholders in the same class; that an unreasonably short time was allowed for the vote to be made; or that disclosure did not comply with the requirements of *section 1126(b) of the Bankruptcy Code*.ⁿ⁴ In addition, *Federal Rule of Bankruptcy Procedure 3018(b)* provides that votes in respect of a security held of record must be cast by the holder of record of the security on the record date specified in connection with the solicitation.ⁿ⁵

[3] *Bankruptcy Code Section 1121(a).*

Section 1121(a) of the Bankruptcy Code provides that a reorganizing company may file a plan of reorganization at the same time that it commences a chapter 11 case. A simultaneous filing would allow a company, immediately upon commencement of a prepackaged chapter 11 case, to move for a hearing to approve the prepetition disclosure statement and confirm the prepackaged plan.ⁿ⁶ Such a hearing generally requires 25 days' notice to parties in interest.ⁿ⁷ This notice period generally sets the minimum period required for confirmation of a prepackaged plan.ⁿ⁸ However, *Federal Rule of Bankruptcy Procedure 9006(c)* permits the bankruptcy court, in its discretion and for cause shown, to reduce

this and various other time requirements under the Bankruptcy Rules.ⁿ⁹

[4] Bankruptcy Code Section 1102(b)(1).

Section 1102(b)(1) of the Bankruptcy Code provides that a prepetition creditors' committee may be appointed as an official creditors' committee in a chapter 11 case provided that the committee was "fairly chosen and is representative of the different kinds of claims to be represented."ⁿ¹⁰ *Federal Rule of Bankruptcy Procedure 2007* sets forth the basis upon which a prepetition committee may be found to have been fairly chosen.ⁿ¹¹

In practice, a prepetition committee may not meet the rigorous requirements of *Federal Rule of Bankruptcy Procedure 2007*. Nevertheless, section 1102(b)(1) of the Bankruptcy Code does not prevent the United States trustee from independently selecting the members of a prepetition committee. The continuation of a prepetition committee that had negotiated a prepackaged plan as the official committee during the prepackaged bankruptcy would expedite the chapter 11 case.

In pre-negotiated cases (that is, in cases where solicitation of votes occurs after the commencement of the bankruptcy), creditors should consider carefully the impact of "lock-up" agreements on their ability to participate on the official committee. Such agreements typically seek to bind creditors to vote for a plan that was negotiated with an ad hoc committee prior to the filing of the case. However, in the wake of the *NII Holdings* ⁿ¹² bankruptcy, the United States Trustee for Region 3 (which includes the District of Delaware) has taken the position that creditors who enter into such arrangements are likely to be disqualified from serving on the official committee. The rationale for this position is that creditors who are "locked up" in support of a pre-arranged plan may have fewer (or different) incentives to challenge the terms of such plan during the pendency of the case. Accordingly, the argument goes, such creditor is not representative of other creditors with similar claims.

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 1126(b).

(n2)Footnote 2. *Id.* See P 6.07[2] *infra* for a discussion of disclosure requirements.

(n3)Footnote 3. See *Fed. R. Bankr. P. 3018(b)*.

(n4)Footnote 4. See P 6.07 *infra* for a description of the requirements of *Fed. R. Bankr. P. 3018(b)* and other aspects of solicitation.

(n5)Footnote 5. But see *In re Southland Corp.*, 124 B.R. 211 (Bankr. N.D. Tex. 1991) (only the beneficial owner of a claim or its authorized agent may vote to accept or reject a plan, and references to record holders in *Fed R. Bankr. P. 3018* are improper substantive changes to the Bankruptcy Code and of no effect). See P 6.07[3][a] *infra* for a discussion of this decision and its impact on solicitation procedures.

(n6)Footnote 6. Once a disclosure statement has been filed, a date for an approval hearing may be set. *Fed. R. Bankr. P. 3017(a)*, amended in 1997. *Fed. R. Bankr. P. 3017(a)* does not apply to small business chapter 11 cases. For procedures regarding the approval of a disclosure statement in a small business case, see *Fed. R. Bankr. P. 3017.1*.

(n7)Footnote 7. See *Fed. R. Bankr. P. 2002(b)* and *3017(a)*.

(n8)Footnote 8. In addition to a hearing to approve the disclosure statement and confirm the plan, a meeting of creditors must be held during the chapter 11 case not less than 20 or more than 40 days after its commencement. *Fed. R. Bankr. P. 2003(a)*. Twenty days' notice by mail of the meeting is required. *Fed. R. Bankr. P. 2002(a)(1)*.

(n9)Footnote 9. *Fed. R. Bankr. P. 9006(c)*. See also 11 U.S.C. § 341(a) (stating that the United States trustee shall hold a meeting "within reasonable time" after the order for relief). However, the meeting of creditors may not be held

sooner than 20 days after commencement of a chapter 11 case. *Fed. R. Bankr. P. 9006(c)(2)*. For prepackaged bankruptcies filed in the Bankruptcy Court of the Southern District of New York, "Official Notice shall be mailed at least twenty (20) days prior to the scheduled hearing date on confirmation of the plan and adequacy of disclosure unless the Court shortens such notice period." In the Matter of the Adoption of Prepackaged Chapter 11 Case Guidelines, General Order 203, Amending General Order 201, Part X. D. (Bankr. S.D.N.Y. February 24, 1999). *See P 6.08[4] infra* (discussing General Order 201). *See also* General Order 203, Southern District of New York, *reprinted in* Collier Bankruptcy Practice Guide, Local Rules of the Bankruptcy Courts; Second Circuit, SDNY 68-78 (Matthew Bender 2002); S. E. Mayerson, *Current Developments in Prepackaged Bankruptcy Plans*, 838 PLI/Comm 337 (No. A0-00E6 April 2002).

(n10)Footnote 10. 11 U.S.C. § 1102(b)(1).

(n11)Footnote 11. The rule contemplates a formal election at a noticed meeting of creditors. All creditors having unsecured claims of over \$1,000 or the 100 unsecured creditors having the largest claims must have had at least five days' written notice of such meeting, and selection must be by a majority in number and amount of claims of those qualified unsecured creditors voting at such meeting, in person or by proxy. To be qualified to vote, a creditor must meet the requirements to vote in the election of the trustee in a chapter 7 case; such creditor must hold an allowable, undisputed, liquidated, unsecured claim of a kind that would be entitled to distribution in a chapter 7 liquidation, must not have another interest materially adverse to the interest of creditors entitled to such distribution and must not be an insider. Any proxy voted must meet the requirements of *Fed. R. Bankr. P. 2006* as to the solicitation and solicitor of such proxy. *Fed. R. Bankr. P. 2007*. Finally, written minutes of such meeting reporting the names of the creditors present or represented and voting and the amounts of their claims must be kept and made available for inspection. *Fed. R. Bankr. P. 2007(b)(1)*.

(n12)Footnote 12. *In re NII Holdings, Inc.*, 288 B.R. 356 (Bankr. D. Del. 2002) (upholding the United States Trustee's refusal to appoint to the official creditors' committee any bondholder who had previously signed a lock-up agreement with company).



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Collier Business Workout Guide

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CHAPTER 6 Prepackaged Bankruptcies

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P 6.04 When Should a Prepackaged Bankruptcy Be Used?

The troubled company's analysis of whether to attempt an out-of-court workout or to initiate a chapter 11 case¹ will address many of the issues relevant to the evaluation of the use of a prepackaged bankruptcy. If a workout cannot be pursued, a prepackaged chapter 11 will probably not be appropriate.² The company must be in a position to negotiate a plan of reorganization with affected constituencies and to maintain its operations without the protection of the bankruptcy court during those negotiations and the subsequent solicitation of votes on a plan.

In addition, an assessment should be made, in light of the particular facts of each situation, of the likely duration, cost and contentiousness of a chapter 11 case and its effect on the business of the restructuring company.

[1] The Holding Company: Basic Issues.

The simplest use of a prepackaged chapter 11 is in the restructuring of debt securities³ issued by a holding company which has few obligations other than indebtedness for borrowed money and which conducts its operations through subsidiaries.⁴ In these circumstances, the prepackaged chapter 11 is a straight substitute for an exchange offer and the issues to be confronted in the chapter 11 case are limited. The prepackaged chapter 11 is used solely to "close" the public debt restructuring; it does not purport to affect any other obligations of the company, and operations are not brought under the jurisdiction of the bankruptcy court.

[a] The Ability to Negotiate.

It is fundamental to a prepackaged chapter 11 that the restructuring company and the requisite percentages of its impaired creditors and stockholders agree on a plan of reorganization prior to the chapter 11 case. Accordingly, the company must be able to identify, and effectively negotiate with, the holders of the principal obligations it proposes to restructure.⁵

When the restructuring is confined to debt and equity securities, a company is dealing with a limited number of identifiable holders. Moreover, it has become common practice for holders of substantial percentages of the public securities of a troubled company to organize, either on their own initiative or at the invitation of the company, for the purpose of participating directly in the formulation of a restructuring plan.⁶

Other sorts of obligations may pose various obstacles to negotiation and solicitation. In some well-known cases,

companies have sought chapter 11 reorganization as a means of dealing with extensive unliquidated tort liabilities.ⁿ⁷ In such cases, it is probably impossible to identify, let alone negotiate with, the relevant creditor body, which is likely to be large and dispersed. Consequently, the prepetition negotiation and solicitation required for a prepackaged chapter 11 may not be practical. In addition, a prepackaged chapter 11 may not be appropriate when significant contingent obligations owing to parties other than lenders or investors must be restructured, such as significant pension or environmental liabilities.

The use of a prepackaged plan in this context, however, is not impossible.ⁿ⁸ For example, in the case of Fuller Austin Insulation, Fuller-Austin, a company in the business of installing insulation in refineries and petrochemical facilities in Texas, became subject to claims of injury resulting from exposure to asbestos products it was responsible for installing. In order to develop a prepackaged chapter 11 plan, Fuller-Austin called a meeting of all counsel representing current holders of asbestos claims which resulted in the formation of a committee representing current claimants. Fuller-Austin then found independent legal counsel to represent future claimants, and negotiations among Fuller-Austin, its parent DynCorp., the independent legal counsel representing future claimants, and the committee for current claimants began. Under the resulting prepackaged plan, all present and future asbestos claims were to be consolidated and administered through a trust. The trust also succeeded Fuller-Austin and its parent to the rights to any insurance covering the asbestos claims. The plan was filed on September 4, 1998. Several of Fuller-Austin's insurers objected to the plan, arguing that they had standing to do so because the potential impairment of their rights under the plan rendered them parties in interest. The bankruptcy court disagreed, however, and held that the objecting insurers lacked standing to object to the plan. The court thus dismissed the insurers' objections. The plan was subsequently confirmed on November 13, 1998.ⁿ⁹

[b] Certainty as to Claims.

In every case, a restructuring company must look carefully at those claims it intends to leave unimpaired as well as those that are to be restructured. Even if a class of claims is unimpaired under a restructuring plan, there may be disputes over the amount or validity of certain claims in the class that need to be resolved in the course of the prepackaged chapter 11.ⁿ¹⁰

Unimpaired obligations must be considered in determining the feasibility of a plan of reorganization. This is both a prerequisite to confirmationⁿ¹¹ and a practical concern for impaired classes voting on the plan. The determination of feasibility will take into account contingent, unliquidated and disputed claims,ⁿ¹² as well as fixed obligations.

[c] Effect on Operations.

The prepackaged chapter 11 of a holding company will not directly involve operations conducted at a subsidiary level. Eliminating the time-consuming and cumbersome exercise of conducting operations under court supervision both expedites the chapter 11 case and reduces its impact on the restructuring company's business.ⁿ¹³ Nevertheless, association with a chapter 11 debtor may still adversely affect relationships with suppliers, customers and employees.ⁿ¹⁴

[2] The Operating Company: Additional Complications.

Restructuring an operating company, as distinguished from a holding company, in a prepackaged chapter 11, multiplies the number of issues to be confronted, even if the principal goal remains the restructuring of public debt securities. The effect of the chapter 11 case on operations will be more direct and must be carefully considered, as well as the reciprocal effect that including operations will have on the duration, cost and contentiousness of the chapter 11 case.

[a] Effect on Suppliers, Customers, and Employees.

Involving an operating company in a chapter 11 case exposes vital supplier, customer and employee relationships to the damage that often results from an association with bankruptcy. Suppliers may be unwilling to continue to extend credit

terms, customers (depending upon the nature of the business) may be reluctant to place orders with a company whose future they view as uncertain and, likewise, employees may seek alternative employment or suffer a significant decline in morale, in either case adversely affecting operations. In the case of a prepackaged chapter 11, which is necessarily made public well in advance of its commencement,ⁿ¹⁵ the company is subjected to the negative effects of bankruptcy prior to filing and without the benefit of the protective provisions of the Bankruptcy Code.ⁿ¹⁶

An operating company that depends heavily on trade credit for operating liquidity will be particularly vulnerable in the period prior to commencement of the prepackaged chapter 11. Commencement of a chapter 11 case "freezes" payment of prepetition claims until consummation of a plan of reorganization,ⁿ¹⁷ when payments will be made at whatever discount may be provided in the plan. The certainty of delay and the uncertainty of recovery can discourage suppliers from continuing deferred payment terms once plans to pursue a prepackaged chapter 11 are announced. For the same reason, it will not be possible to replace lost trade credit from other outside sources during this period. A significant loss of operating liquidity during this period could force the company to seek the protection of the bankruptcy court before its plan of reorganization can be fully negotiated and acceptances solicited over an adequate solicitation period. If a premature filing is required, the company would lose many of the benefits of a prepackaged chapter 11 and face the correspondingly increased uncertainties of a regular chapter 11 case.

[i] Public Relations.

The success of most prepackaged chapter 11 cases will depend on the ability of the company to maintain the cooperation of its creditors and suppliers and the confidence of its employees and customers during the process, especially in the pre-filing period. Essential to this effort will be a well-prepared public relations campaign, the aim of which will be to highlight the differences between the prepackaged chapter 11 and a regular chapter 11 case.

As appropriate in the actual circumstances of a given restructuring, this campaign could stress the following points:

- Overleverage, not operational problems, has given rise to the restructuring, which will affect only specified issues of public debt and bank financing.
- A plan of reorganization has been, or is being, negotiated and will be agreed to by all necessary parties prior to the commencement of any bankruptcy case. That plan provides for payment in full of all amounts due suppliers and employees.
- Once begun, because the plan of reorganization has been pre-approved, the bankruptcy case will not be lengthy. If current payment of prepetition trade and employee claims is prohibited in the chapter 11 case, payment in full will not be long delayed.
- Business operations will continue without undue disruption during the prepackaged bankruptcy. The restructuring company expects to continue doing business with its suppliers and customers during that period and in the future, following confirmation of the restructuring plan.

As with any out-of-court restructuring, once it is known that a restructuring is being pursued, public indications of progress will be important. Public announcements may be constrained both by the actual pace of progress being made and by securities law concerns.ⁿ¹⁸ The uncertainty created by long periods of silence can have a damaging effect. Once a negotiated prepackaged plan is publicly announced, it will be important to demonstrate a high degree of support for the plan from negotiating creditor groups. Finally, the public must be shown that the restructuring company has provided for the continuity of operations through the prepackaged bankruptcy.ⁿ¹⁹

The public relations campaign can be carried on at several levels. First, within the limits prescribed by the securities laws, public announcement by press release can be made when a proposed plan of reorganization has been

negotiated.ⁿ²⁰ Next, the disclosure statement, although not aimed at unimpaired classes, may be used to communicate to the public a coherent plan for ensuring continued operations, including the unimpaired treatment of trade creditors and employees. However, to the extent possible, the message should be delivered directly.ⁿ²¹ To this end, it will be important to equip personnel of the restructuring company to present the company's plans to representatives of suppliers and customers with whom they have a personal relationship and to answer questions about the effect of the prepackaged plan and bankruptcy. In addition, a number of restructuring companies have employed outside public relations firms to contact suppliers and customers individually with a specially prepared presentation.

[ii] Southland Trade Order.

A promise of payment in full at the end of a successful prepackaged chapter 11 may not be sufficient to maintain vital trade credit during the pre-filing period. A special order, first obtained in the chapter 11 case of The Southland Corporation ("Southland"),ⁿ²² and now routinely granted in prepackaged and prearranged cases, provides for the continued payment of prepetition trade claims during the chapter 11 case.ⁿ²³

[A] Description of Order.

In its prepetition solicitation, Southland stated its intention, in spite of the general rule that payments of prepetition claims are frozen on the commencement of a bankruptcy, to seek bankruptcy court approval to continue paying the prepetition claims of suppliers that maintained normal credit terms during the prepackaged bankruptcy.ⁿ²⁴ On the date it commenced its prepackaged bankruptcy, the company submitted a motion for an order approving such payments, which was granted by the court.ⁿ²⁵

The Southland Trade Order authorized such payments to any trade creditor that agreed in writing to maintain or reinstate normal credit termsⁿ²⁶ and to the following condition: if that trade creditor thereafter unreasonably ceased giving terms, (i) any amounts it had received postpetition in respect of prepetition claims would be deemed to be advances recoverable by the company in cash or additional goods or services, and (ii) the prepetition claims in respect of which those amounts had been received would be reinstated.ⁿ²⁷ In addition, each payment of prepetition trade claims was required to be made by check stamped with a legend referencing the order of the bankruptcy court and the written agreement of the trade creditor, together with an agreement to submit to the jurisdiction of the bankruptcy for enforcement thereof.ⁿ²⁸ Many courts no longer require such an elaborate mechanism and simply approve payment of all prepetition trade claims.

[B] Statutory Basis of Order.

Section 362 of the Bankruptcy Code prohibits creditors, after the commencement of a bankruptcy case, from taking any action to collect on prepetition claims.ⁿ²⁹ However, there is no express corresponding prohibition on the debtor against paying these claims. *Section 549 of the Bankruptcy Code* provides that any postpetition transfer, including in respect of prepetition claims, may be voided unless authorized under the Bankruptcy Code or by order of the bankruptcy court.ⁿ³⁰ In the absence of an express prohibition, the argument can be made that prepetition claims may be paid with the approval of the bankruptcy court. In turn, courts that have approved critical vendor motions have generally done so based on the broad equitable powers conferred by *section 105 of the Bankruptcy Code*, which provides that the court can issue any order that is "necessary or appropriate" to carry out the provisions of the Bankruptcy Code.ⁿ³¹ Various courts have developed a number of rules, generally grouped under the rubric of the "doctrine of necessity," which permit postpetition payments on prepetition claims that can be shown to be necessary to, or result in, the preservation of the estate and a greater ultimate recovery for interested parties.ⁿ³² Southland, however, did not argue that the actual postpetition payment of prepetition trade claims was essential to preserving its operations; instead, it argued that the preservation of prepetition trade credit, which it had accomplished by promising continued payment postpetition, had been essential to completing the prepetition negotiation and solicitation of its prepackaged plan.ⁿ³³ In other words, payment of prepetition trade obligations was a prerequisite for the use of a prepackaged bankruptcy which, if successful,

would maximize recoveries to all parties. This line of argument is a departure from the estate-preserving arguments of the doctrine of necessity. It is, rather, a request for the bankruptcy court to adopt a new procedure applicable to prepetition solicitations provided for in *section 1126(b) of the Bankruptcy Code*.ⁿ³⁴

Since Southland's prepackaged chapter 11, similar orders have been entered in other chapter 11 cases.ⁿ³⁵ However, the availability of such an order from other courts cannot be assured. Indeed, there is a line of authority that does not accept even the more basic applications of the doctrine of necessity on the grounds that, absent a confirmed plan of reorganization, postpetition payment of prepetition obligations is contrary to the express provisions of the Bankruptcy Code.ⁿ³⁶

The view that critical vendor orders may not be permissible under the Bankruptcy Code received a notable fillip in the *Kmart* case. There, the Seventh Circuit affirmed a district court decision disallowing a critical vendor order.ⁿ³⁷ The district court had ruled that critical vendor orders were *per se* impermissible, on the grounds that a bankruptcy court's general equitable powers under *section 105 of the Bankruptcy Code* did not permit it to override the Code's explicit statutory priority scheme. The Seventh Circuit's holding was less drastic, and left open (without endorsing) the possibility that some critical vendor orders could be justified under the Bankruptcy Code's provision for using or selling estate property outside of the ordinary course of business, with court approval.ⁿ³⁸ Nevertheless, the Seventh Circuit did make it clear that critical vendor orders would be permitted, if at all, only where paying some vendors out of turn clearly benefited *all* unsecured creditors.ⁿ³⁹

[b] Court Oversight of Operations.

Once operations are under the jurisdiction of the bankruptcy court, flexibility will be extremely limited with respect to capital expenditures, asset dispositions and significant contracts, as well as other aspects of the business. All transactions out of the ordinary course require court approval after notice and hearing.ⁿ⁴⁰ While ordinary course operations may continue without court approval,ⁿ⁴¹ the company may find that parties with whom it deals are reluctant to act without such approval.

[c] Case Administration.

Administrative requirements are likely to be more burdensome to execute in a case involving an operating entity and are also likely to add to the cost and duration of the chapter 11 case. Such administrative requirements typically include procedures relating to the oversight of operationsⁿ⁴² and reporting, noticing and other requirements of a chapter 11 case.ⁿ⁴³

[3] Beneficial Bankruptcy Code Provisions.

In addition to the ability to bind dissenting creditors on the basis of a majority vote, a restructuring company may take advantage of other beneficial provisions of the Bankruptcy Code in a prepackaged bankruptcy that are not available in an out-of-court workout. It is significant, however, that these provisions are not available until the chapter 11 case has been commenced.

Section 362 of the Bankruptcy Code acts to stay creditor actions against a restructuring company, including litigation, proceedings before the United States Tax Court, the enforcement of judgments and the exercise of contractual and statutory remedies.ⁿ⁴⁴ The automatic stay is intended to give the restructuring company "breathing space" in which it may negotiate and implement a plan of reorganization.

It will often be difficult for a company pursuing an out-of-court restructuring to obtain financing while there is uncertainty as to whether the restructuring will succeed. To help alleviate that difficulty, *section 364 of the Bankruptcy Code* provides special inducements to lenders providing debtor-in-possession, or "DIP," financing after the

commencement of a chapter 11 case.ⁿ⁴⁵

Section 365 of the Bankruptcy Code gives the restructuring company considerable leeway in maintaining significant executory contracts and unexpired leases that have not been terminated prior to the commencement of the bankruptcy case, regardless of whether there are existing defaults.ⁿ⁴⁶ Generally, a company has until confirmation of a plan to evaluate its contracts and leases, assume those that are favorable, and reject those that are burdensome.ⁿ⁴⁷ However, it will not generally be advantageous to undertake a thorough-going restructuring of executory contracts and unexpired leases in a prepackaged bankruptcy.ⁿ⁴⁸

Section 1124(2) of the Bankruptcy Code gives the restructuring company an enhanced ability to cure defaults and reinstate the originally scheduled maturities of any accelerated contractual payment obligations.ⁿ⁴⁹

FOOTNOTES:

(n1)Footnote 1. *See* ch. 2 *supra*.

(n2)Footnote 2. There are important exceptions. First, a prepackaged chapter 11 will eliminate holdouts that may be an obstacle to an out-of-court workout. *See* P 6.02 *supra*. Second, in a prepackaged chapter 11, a company may take advantage of certain beneficial provisions of the Bankruptcy Code that are not available outside of a chapter 11 case. These provisions may assist in overcoming some obstacles to an out-of-court workout by, for example, staying the exercise of creditors' remedies and facilitating working capital financing. *See* P 6.04[3] *infra*. In addition, a more advantageous tax treatment afforded restructurings effected in a chapter 11 case may eliminate substantial tax costs of an out-of-court workout. *See* ch. 8 *infra*.

(n3)Footnote 3. In addition, a restructuring of bank debt is very likely to accompany a restructuring of public debt securities. Bank debt restructurings generally continue to be treated as unanimous consent transactions that are "folded" into the prepackaged plan, rather than effected through a class vote. *See* P 6.05[7] *infra*.

(n4)Footnote 4. The highly leveraged holding company posited here is common to many leveraged buyouts. However, circumstances are rarely as simple as described. There may be some operations at the holding company level or operating subsidiaries may guarantee the obligations to be restructured. To the extent operations are implicated, the considerations raised in P 6.04[2] *infra* will be relevant.

(n5)Footnote 5. Negotiations with impaired classes are not required as a legal matter. They are undertaken to enhance the likelihood that, when put to a vote, the negotiated plan of reorganization will be accepted by the requisite percentages of creditors and stockholders. Failure to negotiate with an impaired class does not in itself rule out the possibility of a prepackaged bankruptcy. The requisite acceptances may be forthcoming regardless; or, when the claims involved are sufficiently small, the plan may be structured to provide for an alternative unimpaired treatment at the company's option. 11 U.S.C. § 1122(b). Finally, depending upon the circumstances, it may be possible to subject the class to a cramdown. *See* P 1.09[3][c] *supra* and P 6.08[3] *infra*.

(n6)Footnote 6. *See* P 5.04 *supra*. Although such circumstances make negotiations possible, agreement may not always follow. Serious debtor-creditor or intercreditor issues may exist (such as a loss of confidence in management or disagreement over legal entitlements) that must be settled before any agreement on a plan of reorganization can be reached. It may be that these matters can only be resolved through the mechanisms of a chapter 11 case, such as appointment of a trustee to replace management or litigation of equitable subordination or avoidance actions. On the other hand, the prospect of a contested bankruptcy may induce agreement on a prepackaged plan in settlement of these issues.

(n7)Footnote 7. *See, e.g., In re Babcock & Wilcox, Co., No. 00-0558, 2000 U.S. Dist. LEXIS 5626 (E.D. La. Apr. 17, 2000) ; Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.), 801 F.2d 60, 62 (2d Cir. 1986) ; Ackles v. A.H. Robins Co. (In re A.H. Robins Co.), 59 B.R. 99, 101 (Bankr. E.D. Va. 1986) . In re Combustion Eng'g,*

Inc., 391 F.3d 190 (3d Cir. 2005) .

(n8)Footnote 8. *In re Fuller-Austin Insulation, Case No. 98-2038, 1998 U.S. Dist. LEXIS 18340* (D. Del. Nov. 10, 1998) . *See also In re A.P.I., Inc.*, 331 B.R. 828 (Bankr. D. Minn. 2005) . Halliburton's chapter 11 case provides another example. In that case, a future claimant representative was engaged to represent future asbestos claimants in prepetition negotiations. The bankruptcy court confirmed the resulting prepackaged plan of two Halliburton subsidiaries approximately eight months after it was filed, finding that all of the parties were adequately represented and the negotiations had been at arm's length. Eric D. Green et al., *Prepackaged Asbestos Bankruptcies: Down But Not Out*, 63 *N.Y.U. Ann. Surv. Am. L.* 727, 767-71 (2008).

(n9)Footnote 9. S. E. Mayerson, *Current Developments in Prepackaged Bankruptcy Plans*, 787 *PLI/Comm* 937 (No. A0-0022 April 1999).

(n10)Footnote 10. A dispute over the amount or validity of a claim must be distinguished from treating that claim as impaired. A claim is not impaired if its actual legal, equitable or contractual entitlements are not altered. 11 U.S.C. § 1124, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). This concept does not depend on what the holder asserts its entitlements to be.

(n11)Footnote 11. To be confirmed, a plan of reorganization must be feasible, that is, the organizing company must not be likely to require further financial reorganization or a liquidation after the plan has been put into effect unless such liquidation or reorganization is proposed in the plan. 11 U.S.C. § 1129(a)(11).

(n12)Footnote 12. For example, potential environmental or pension liabilities and contract, tort or other claims of employees, customers and other parties must be considered. An operating company is more likely than a holding company to harbor unanticipated claims of this sort.

(n13)Footnote 13. *See P 6.04[2][b] and [c] infra.*

(n14)Footnote 14. *See P 6.04[2][a] infra.* However, when operations are not actually subject to the chapter 11 case, public opinion should be more likely to respond to a well-prepared public relations campaign. *See P 6.04[2][a][i] infra.*

(n15)Footnote 15. Generally, a contemplated prepackaged chapter 11 will become widely known at least when the prepetition solicitation is commenced. *See P 6.07[3][c] infra* for a discussion of the length of this solicitation period. If the solicitation is subject to the requirements of section 5 of the 1933 Act, 15 U.S.C. § 77(e), the contemplated chapter 11 case will be publicly disclosed upon the initial filing of the restructuring company's registration statement with the SEC. This filing will necessarily precede commencement of solicitation by several weeks. *See P 5.07[2] supra.*

(n16)Footnote 16. *See P 6.04[3] infra.*

(n17)Footnote 17. The automatic stay prohibits creditor collection actions. 11 U.S.C. § 362, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). Payments made voluntarily without approval of the bankruptcy court are avoidable. 11 U.S.C. § 549, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n18)Footnote 18. *See P 5.05[1] supra.*

(n19)Footnote 19. One of the most important actions that can be taken in this regard is to make provision for adequate debtor-in-possession financing. *See P 6.06[1]&[2] infra.*

(n20)Footnote 20. *See P 5.05[1] supra.*

(n21)Footnote 21. In the case of The Southland Corporation, simultaneously with the public announcement of its prepackaged plan, the company communicated by fax to its largest trade creditors a proposal to continue payment of prepetition trade claims during its prepackaged bankruptcy. *See P 6.04[2][a][ii] infra.* Thereafter, the company contacted over 75,000 trade creditors by mail. The company claimed, except in the case of one significant supplier, to have experienced no significant reduction in trade credit between the first announcement of its prepackaged plan and the commencement of its prepackaged bankruptcy 30 days later. *In re Southland Corp.*, 124 B.R. 211 (Bankr. N.D. Tex. 1991) (Emergency Motion for Order Authorizing Debtor-in-Possession to Pay Pre-Petition Claims of Trade Creditors Who Consent to Continue or Reinstate Customary Trade Terms, and Brief, dated Oct. 24, 1990) [the "Southland Trade Order Brief"].

(n22)Footnote 22. *In re Southland Corp.*, 124 B.R. 211 (Bankr. N.D. Tex. 1991) (Emergency Order Granting and Modifying Authorization to Pay Pre-Petition Claims of Trade Creditors Who Consent to Continue or Reinstate Customary Trade Terms, dated Oct. 26, 1990) [the "Southland Trade Order"].

(n23)Footnote 23. Employees have similar concerns regarding prepetition wages and benefits and, to a lesser extent, customers have similar concerns regarding prepetition warranty and other product related claims. Orders regarding continued payment of such claims have a longer history. *See P 9.08[5][a] infra.*

(n24)Footnote 24. The Southland Corporation, Proxy Statement-Prospectus 14 (Oct. 5, 1990).

(n25)Footnote 25. *See Southland Trade Order Brief*, n.21 *supra* , and *Southland Trade Order*, n.22 *supra*.

(n26)Footnote 26. For the purposes of the Southland Trade Order, "normal credit terms" was defined to mean, with respect to any supplier, either (i) the terms in effect between such supplier and the company on March 22, 1990 (identified in the *Southland Trade Order Brief*, n.21 *supra* , P 22, as the date after which Southland began to experience a deterioration in trade terms); (ii) if none existed on such date, terms no less favorable than terms given by such supplier to its other customers; or (iii) such other terms as may be agreed to by the company and such supplier and approved by an accountant acting on behalf of the company's prepetition secured bank lenders and a representative with trade credit experience designated by the official unsecured creditors' committee. *Southland Trade Order*, n.22 *supra* , P 4. In addition, the order provided that any supplier, the company, or the bank's accountant or the committee's designee could request a written clarification of the terms to be supplied if there was reasonable cause to believe that confusion existed as to such terms. *Southland Trade Order*, n.22 *supra* , P 6.

(n27)Footnote 27. *Southland Trade Order*, n.22 *supra* , P 7.

(n28)Footnote 28. Further, the order provided that such payments would be suspended if a proposed new investment of \$430 million in the company, an essential element of the prepackaged plan, fell through. *Southland Trade Order*, n.22 *supra* , P 11.

(n29)Footnote 29. 11 U.S.C. § 362, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n30)Footnote 30. 11 U.S.C. § 549, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n31)Footnote 31. *See, e.g., In re Just for Feet, Inc.*, 242 B.R. 821, 824 (D. Del. 1999) ; *In re CoServ, L.L.C.*, 273 B.R. 487, 497 (Bankr. N.D. Tex. 2002) ; *In re Eagle-Picher Indus.*, 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991) ; *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 175-79 (Bankr. S.D.N.Y. 1989) . *But see Capital Factors, Inc. v. Kmart Corp.*,

2003 U.S. Dist. LEXIS 17437 (N.D. Ill. Sept. 29, 2003) (refusing to apply the section 105 doctrine of necessity to authorize payments to critical trade vendors and issuers of prepetition letters of credit). The bankruptcy court's broad equitable powers under section 105 are well established in the caselaw. See, e.g., *Katchen v. Landy*, 382 U.S. 323, 327 (1966) ("[bankruptcy] courts are essentially courts of equity") (pre-1978 Bankruptcy Reform Act, Pub. L. No. 95-598, case); *In re Exquisito Services, Inc. United States (In re Exquisito Servs., Inc.)*, 823 F.2d 151, 155, 17 C.B.C.2d 324 (5th Cir. 1987) ("Bankruptcy courts have traditionally been considered courts of equity, with full equitable powers.").

(n32)Footnote 32. See, e.g., *In re Boston & Maine Corp.*, 634 F.2d 1359 (1st Cir. 1980), cert. denied, 450 U.S. 982, 101 S. Ct. 1518, 67 L. Ed. 2d 817 (1981) (discussing "Six Months Rule" developed in railroad reorganizations permitting payment of current operating expenses incurred within six months before petition date for goods and services delivered in expectation that they would be paid from current operating revenue rather than in reliance on the railroad's general credit); *In re McLean Indus., Inc.*, 103 B.R. 424 (Bankr. S.D.N.Y. 1989) (concluding that the "Six Months Rule" applies only to railroad reorganization cases and is not applicable to other chapter 11 cases, including where the debtor may have been engaged in the transportation business). Cf. *In re Michigan Interstate Ry. Co.*, 19 C.B.C.2d 21, 87 B.R. 921, 925 (Bankr. E.D. Mich. 1988) (observing that caselaw has no unified principle with respect to priority requests for prepetition claims in railroad reorganizations pursuant to the "Six Months Rule" and refusing to state that there are only two sets of circumstances under which the "Six Months Rule" can be applied). See also *In re Jensen-Farley Pictures, Inc.*, 47 B.R. 557 (Bankr. D. Utah 1985) (discussing "direct benefit" rule permitting payment of reasonable compensation and reimbursement of expenses in connection with prepetition services directly benefiting the debtor's estate, and "equitable benefit" doctrine permitting reimbursement of expenses incurred prepetition in the preservation of the estate); *In re Best Prods. Co.*, 173 B.R. 862, 866 (Bankr. S.D.N.Y. 1994) (listing factors to determine whether a creditor has made a substantial contribution, which include whether the services: were provided to benefit the estate itself or all of the parties in the bankruptcy case; conferred a direct, significant and demonstrably positive benefit upon the estate and were duplicative of services performed by others); *In re Just for Feet, Inc.*, 242 B.R. 821, 825 (D. Del. 1999) (debtor must show payment of prepetition claims is critical to debtor's reorganization). *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989) (discussing "necessity of payment" rule permitting payment of prepetition obligations where such payment is essential to the continued operation of the debtor); *In re CoServ, L.L.C.*, 273 B.R. 487, 498-99 (Bankr. N.D. Tex. 2002) (adopting three-part test to be applied in resolving whether debtor can pay a general unsecured prepetition claim: the debtor must prove by a preponderance of the evidence (i) that it is critical for the debtor to deal with the claimant; (ii) that unless it does, the debtor will risk the probability of harm or, alternatively, loss of economic advantage to the estate or the debtor's going concern value, which is disproportionate to the amount of the claimant's prepetition claim; and (iii) that there is no practical or legal alternative by which the debtor can deal with the claimant other than by payment of the claim); R. A. Eisenberg and F. F. Gecker, *The Doctrine of Necessity and Its Parameters*, 73 Marq. L. Rev. 1 (1989). (emphasizing that the purpose of the doctrine of necessity is to ensure an effective reorganization). But see *In re Mirant Corp.*, 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003) (declining to require debtors to first obtain advance court approval after satisfying the three-part test set forth in *In re CoServ* as a prerequisite to providing preferential treatment for certain critical vendors, to avoid risk that the debtors' business of generating and selling electric power might otherwise be interrupted).

(n33)Footnote 33. See *Southland Trade Order Brief*, n.21 *supra*, PP 45 and 46.

(n34)Footnote 34. *Southland Trade Order*, n.22 *supra*, P 46 ("[T]he bankruptcy courts have been left with the task of fashioning mechanisms and remedies to enable the use of [prepackaged bankruptcies], including those requested in this Motion"). See generally *In re Global W. Dev. Corp.*, 759 F.2d 724, 727 (9th Cir. 1985) (stating that bankruptcy courts, as courts of equity, may devise new remedies when those at law are inadequate) (citing *In re Hadeline Nursing Homes*, 694 F.2d 433, 436 (6th Cir. 1982)); *In re Chateaugay Corp.*, 80 B.R. 279, 287 (S.D.N.Y. 1987) (fundamental purpose of equity powers of the court "is to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately."). But see *Capital Factors, Inc. v. Kmart Corp.*, 2003 U.S. Dist. LEXIS 17437, *10 (N.D. Ill. Sept. 29, 2003) ("[W]e cannot ignore the Bankruptcy Code's statutory scheme of priority in favor of 'equity,' especially in light of the Seventh Circuit's admonition that 'the fact that

a [bankruptcy] proceeding is equitable does not give the judge a free-floating discretion to redistribute rights in accordance with his personal views of justice and fairness, however enlightened those views may be." (citing *In re Chicago Milwaukee, St. Paul & Pac. R.R. Co.*, 791 F.2d 524, 528 (7th Cir. 1986)).

(n35)Footnote 35. See *Trump Taj Mahal Assocs. v. Alibraham (In re Trump Taj Mahal Assocs.)*, 156 B.R. 928 (Bankr. D.N.J. 1993) (Order Granting Motion for Order Authorizing Payment of Pre-Petition Trade Debt by Trump Taj Mahal Associates, dated July 17, 1991); *In re Memorex Telex Corp.*, No. 92-8 (Bankr. D. Del. Jan. 6, 1992) (Order Authorizing Payment of Pre-Petition Trade Claims of Trade Creditors Who Consent to Continue Customary Trade Terms or Who Have Agreed to Compromise Their Claims, dated Jan. 6, 1992); *Pension Benefit Guar. Corp. v. Sharon Steel Corp. (In re Sharon Steel Corp.)*, 159 B.R. 730, 736 (Bankr. W.D. Pa. 1993) (permitting the payment of prepetition wage claims prior to plan confirmation); *In re Quality Interiors, Inc.*, 127 B.R. 391, 396 (Bankr. N.D. Ohio 1991) (recognizing that bankruptcy courts often permit the payment of pre-petition wages so that the debtor in possession can maintain an effective work force).

(n36)Footnote 36. *In re FCX, Inc.*, 14 C.B.C.2d 1281, 60 B.R. 405 (E.D.N.C. 1986) (arguing that postpetition payment of prepetition claims effectively re-orders the priority rules articulated in section 507(a) of the Bankruptcy Code); *Official Comm. of Equity Sec. Holders v. Mabey*, 832 F.2d 299, 17 C.B.C.2d 1210 (4th Cir. 1987), cert. denied, 485 U.S. 962, 108 S. Ct. 1228, 99 L. Ed. 2d 428 (1988); *In re Timberhouse Post & Beam, Ltd.*, 196 B.R. 547, 550-51 (Bankr. D. Mont. 1996) (adopting a "bright line rule ... that a prepetition unsecured claim cannot be elevated to an administrative expense since the scheme of the 1978 Bankruptcy Code does not allow this Court to change the classification of claims set by Congress in the Code"); *Chiasson v. J. Louis Matherne & Assocs. (In re Oxford Mgmt., Inc.)*, 4 F.3d 1329, 1334, 30 C.B.C.2d 97 (5th Cir. 1993) (payment of a prepetition claim prior to confirmation of a chapter 11 plan was contrary to the provisions of the Code). But see *In re Chateaugay Corp.*, 80 B.R. 279, 287 (S.D.N.Y. 1987) (declining to follow *In re FCX*, stating that "[a] rigid application of the priorities of § 507 would be inconsistent with the fundamental purpose of reorganization and of the Act's grant of equity powers to bankruptcy courts, which is to create a flexible mechanism that will permit the greatest likelihood of survival of the debtor and payment of creditors in full or at least proportionately.").

(n37)Footnote 37. See *In re Kmart Corp.*, 359 F.3d 866 (7th Cir. 2004), aff'g *Capital Factors, Inc. v. Kmart Corp.*, 2003 U.S. Dist. LEXIS 17437 (N.D. Ill. 2003).

(n38)Footnote 38. See *In re Kmart*, 359 F. 3d at 872-73 (7th Cir. 2004) (finding that in order to use section 363 for this purpose it would be "necessary to show not only that the disfavored creditors will be as well off with reorganization as with liquidation ... but also that the supposedly critical vendors would have ceased deliveries if old debts were left unpaid while the litigation continued"); 11 U.S.C. § 363(b)(1), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n39)Footnote 39. See *In re Kmart*, 359 F. 3d at 874 (7th Cir. 2004). See generally, Lynn P. Harrison 3d, et al., *First Day Orders: A Critique on Critical Vendor Motions*, in 26th Annual Current Developments in Bankruptcy & Reorganization, vol. 2, 467, 477-78 (2004). The Seventh Circuit in *Kmart* took a jaundiced view of the traditional "doctrine of necessity" justification for critical vendor orders. In particular, the court noted that credit extended post-petition would be granted administrative-expense status, and generally could be expected to be paid in full. Given this fact, for vendors "[t]o abjure new profits because of old debts would be to commit the sunk-cost fallacy," the Seventh Circuit reasoned. "They might as well burn money or drop it into the ocean." *In re Kmart*, 359 F. 3d at 873 (7th Cir. 2004). The case for critical vendor orders may be stronger in prepackaged bankruptcies, where the pre-petition claims of trade creditors are typically paid in full under the reorganization plan.

(n40)Footnote 40. 11 U.S.C. 363(b)(1), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n41)Footnote 41. *11 U.S.C. 363(c)(1)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n42)Footnote 42. *See P 6.04[2][b] supra*.

(n43)Footnote 43. *See ch. 9 infra*.

(n44)Footnote 44. *11 U.S.C. § 362*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n45)Footnote 45. *11 U.S.C. § 364*. *See P 6.06[2] infra* for a discussion of DIP financing.

(n46)Footnote 46. *11 U.S.C. § 365*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n47)Footnote 47. *11 U.S.C. § 365(d)(2)*. Exceptions include leases of non-residential real estate and situations in which the bankruptcy court orders otherwise upon motion of a party in interest. *11 U.S.C. § 365(d)(4)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised), and *11 U.S.C. § 365(d)(2)*.

(n48)Footnote 48. *See P 6.05[5] infra*.

(n49)Footnote 49. *11 U.S.C. § 1124(2)*.



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Collier Business Workout Guide

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CHAPTER 6 Prepackaged Bankruptcies

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P 6.05 Formulating the Prepackaged Plan.

The principal goal of a prepackaged chapter 11 is assumed to be the restructuring of public debt that could not be restructured, or restructured as efficiently, in an out-of-court workout. Generally, this goal can be best served if additional matters that could prolong and possibly disrupt the chapter 11 case are addressed only when the benefits of doing so outweigh likely detrimental effects on the process. The prepackaged plan should be formulated with these considerations in mind.

[1] Who Needs to File?

An initial determination may be required in order to select the member or members of a multi-entity corporate group that should be included in the prepackaged bankruptcy. Generally, there are three reasons for a member of the group to join the chapter 11 case: (i) it is an obligor with respect to an obligation being restructured under the prepackaged plan;ⁿ¹ (ii) it may require the protection of the bankruptcy court in connection with cross-defaults under significant contractual obligations triggered by the participation of related entities in the prepackaged bankruptcy; and (iii) it may seek to facilitate the financing of its own operations or the operations of related entities during the chapter 11 case.

[a] All Obligors.

Generally, in addition to direct obligors, all guarantors of obligations to be restructured must be included in the prepackaged bankruptcy. This is necessary both to effect the restructuring of their guarantee obligations and to preclude actions on the guarantee during the prepackaged bankruptcy by creditors dissenting from the prepackaged plan. A guarantor that has no direct obligations to be restructured may not need to join the prepackaged bankruptcy if the holders of the guaranteed obligations unanimously consent to the prepackaged plan. This consent must be reliably assured prior to the actual solicitation of votes, so that the prepackaged plan can be structured to exclude the guarantor. If the corporate entity is a guarantor of widely held public debt, unanimity is generally assumed to be impossible and the corporation will be required to join the prepackaged chapter 11.ⁿ²

[b] Protection.

The bankruptcy filing of one entity can trigger cross-defaults under loan agreements, leases and other contractual obligations of related entities. In such cases, an entity that otherwise has no obligations to be restructured may need to join the prepackaged bankruptcy to protect itself from the exercise of remedies under defaulted loan agreements and to

preserve essential leases and contracts. Accordingly, existing contractual obligations of related entities proposed to be left out of a prepackaged bankruptcy should be carefully reviewed.

[c] Postpetition Financing.

An entity that would otherwise be left out of the prepackaged bankruptcy may depend for financing on related entities that will join the prepackaged bankruptcy or may participate in a consolidated cash management system with such entities. The continued flow of cash from the debtor entities to the nondebtor entity would require the approval of the bankruptcy court. Whether and on what terms such approval would be granted cannot be assured in advance.ⁿ³

When an entity has its own sources of financing, the continued availability of these sources needs to be assured. Contractual lines of credit must be reviewed for vulnerability to cross-defaults triggered by the anticipated bankruptcy filing of related entities. In addition, adverse publicity surrounding the bankruptcy filing of related entities could have a detrimental effect on operations and threaten continued availability of trade credit and other uncommitted financing. If, in light of these considerations, continued adequate financing cannot be assured, the entity may have to join the prepackaged bankruptcy in order to avail itself of DIP financing.

If DIP financing is to be obtained, prospective postpetition lenders may require filing by all entities with substantial assets, whether or not they would otherwise join the prepackaged bankruptcy, in order to facilitate the grant of superpriority liens on such assets.ⁿ⁴

[2] The Prepackaged Plan: Basic Principles.

The Bankruptcy Code imposes a number of requirements on a plan of reorganization, including a prepackaged plan.ⁿ⁵ Some of these requirements are technical.ⁿ⁶ Other more fundamental requirements are in line with the "common sense" of a restructuring plan and should follow almost automatically from negotiations. However, they must be borne in mind since a prepackaged plan is subject to attack if deficient in any of these regards.ⁿ⁷

[a] Classification of Claims and Interests.

A plan of reorganization is required to divide all claims and equity interests into classes, identify those classes that will be left unimpaired and those that will be restructured and specify the treatment that will be accorded each impaired class.ⁿ⁸ There are three fundamental requirements with respect to classifications designed to preserve equality of treatment of similarly situated impaired parties: (i) each class must consist only of claims or interests that are substantially similar to the other claims or interests in that class;ⁿ⁹ (ii) each claim or interest within a class must be treated alike, unless the holder of that particular claim or interest consents to a less favorable treatment of such particular claim or interest;ⁿ¹⁰ and (iii) claims or interests that are substantially similar should not be placed in separate classes with the result that they receive unequal treatment.ⁿ¹¹

There are no precise rules for determining proper classification. Generally, in the case of debt and equity securities, classification may follow lines of contractual priority and, in the case of secured debt, differentiation may be made on the basis of the assets securing the claims.

[b] Minimum Treatment.

Perhaps the most important feature of a prepackaged plan is the ability to bind dissenting holders by a class vote. However, to be bound, a dissenting holder in an accepting class must receive or retain under the prepackaged plan at least the value that would be received by that holder in a liquidation under chapter 7 of the Bankruptcy Code.ⁿ¹²

A disclosure statement used to solicit votes on a prepackaged plan should include a liquidation analysis comparing recoveries under the plan with those in liquidation to demonstrate that the "best interests" test is satisfied. Disclosure

materials used in traditional exchange offers have historically avoided taking a position on valuation.ⁿ¹³

[c] Feasibility.

The prepackaged plan must be a reasonably "permanent" solution that is not likely to be followed by the need for further financial restructuring.ⁿ¹⁴ In determining feasibility, the bankruptcy court will consider the capital structure, projected earnings, capabilities of management, the probability of their continued tenure and other relevant matters. This will include some evaluation of contingent, disputed and unliquidated liabilities.

[3] Treatment of Claims or Interests: Impaired or Unimpaired.

Any class that is impaired is entitled to vote on the prepackaged plan. The plan cannot be confirmed if an impaired class has voted against it, except through a "cramdown" of the dissenting class.ⁿ¹⁵ Accordingly, impaired treatment of a class will have a significant effect upon the acceptance and confirmation of the prepackaged plan. Generally, the multiplication of impaired classes will increase the burdens of solicitation, reduce the chances of receiving the necessary votes and provide more opportunity for dispute in the chapter 11 case.

The Bankruptcy Code explains the concept of impairment by defining when a claim or interest is not impaired.ⁿ¹⁶ The two treatments that are deemed to leave a claim or interest unimpaired are: (i) leaving unaltered the legal, equitable, or contractual rights to which its holder is entitled; and (ii) with respect to a claim or interest that has come due prepetition upon the occurrence of some event of default, curing such default (other than any default under an *ipso facto*, or bankruptcy, clause or any default not required to be cured pursuant to 11 U.S.C. § 365(b)(2)),ⁿ¹⁷ reinstating the original maturity of such claim or interest, compensating the holder of such claim or interest for certain damages arising from reliance upon the contractual provisions of such claim or interest or for any actual pecuniary losses incurred due to the failure to perform certain nonmonetary obligations and otherwise leaving unaltered the legal, equitable and contractual rights to which its holder is entitled.ⁿ¹⁸

[4] Ordinary Course Contingent or Disputed Claims.

Most restructuring companies will face a number of contingent or disputed claims arising in the ordinary course of their operations. These claims are difficult to treat as impaired for two reasons. First, they will generally fall into the class of the company's general unsecured obligations, which often are left unimpaired in a prepackaged plan. This is the broadest class of claims, which will include, among others, claims of trade suppliers, customers and employees. All claims within a class must receive similar treatment. For example, customer warranty claims may not be discounted while supplier claims receive full payment. Second, even if a certain class of contingent or disputed claims could be distinguished from other general obligations so as to justify dissimilar treatment, solicitation may be impracticable or impossible in the context of a pre-packaged plan.

Accordingly, it will generally be necessary to treat these claims as unimpaired. This may be accomplished by leaving these liabilities undischarged under the prepackaged plan, to be paid as they become fixed by the passage of time or resolved through litigation. The economic effect of these liabilities is left uncertain under this treatment, which raises a feasibility issue that may have to be addressed in order for the prepackaged plan to be confirmed.ⁿ¹⁹ Alternatively, the bankruptcy court has the power under *section 502(c) of the Bankruptcy Code* to fix the amount of contingent or unliquidated claims.ⁿ²⁰ This option allows such liabilities to be resolved and discharged expeditiously when the amount as liquidated can be paid in full upon consummation of the prepackaged plan. However, the litigation involved in the estimation procedure may prolong and disrupt the prepackaged bankruptcy.

Impaired parties may be unwilling to commit to a prepackaged plan that provides for unimpaired treatment of significant contingent or disputed liabilities, the value of which cannot be known at the time of voting. In order to win acceptance, it may be necessary to provide in the disclosure statement that the company will seek estimation of all

significant contingent or disputed liabilities and to set a cap for the amount of such liabilities that would be a condition to plan confirmation and, if exceeded, would require a resolicitation of acceptances.

[5] Burdensome Contracts and Leases.

The power under *section 365(a) of the Bankruptcy Code* to reject executory contracts and unexpired leases should be used cautiously in a prepackaged bankruptcy. Rejection may not necessarily be economically advantageous. A prepetition claim for damages is created,ⁿ²¹ and this claim must be paid in its full liquidated amount either at consummation or when finally resolved in order for it to be considered unimpaired.ⁿ²² Absent an individually negotiated settlement, it will generally not be possible to impair rejection claims.ⁿ²³ However, certain above-market employment contracts and real property leases might be advantageously terminated without being treated as impaired. The allowable amount of a claim arising upon the rejection of an employment contract or real property lease is limited by the Bankruptcy Code: in the case of employment contracts, one year's compensation;ⁿ²⁴ and in the case of non-residential real property leases, the greater of (i) one year's rent or, (ii) 15 percent of the rent reserved for the remaining term (not to exceed three years' rent).ⁿ²⁵

[6] Securities Litigation Claims.

Many highly leveraged companies facing a need to restructure must address a common type of contingent liability: securities litigation claims arising from the original leveraging transactions. Such claims generally are amenable to treatment as class actions, which allows them to be treated *en bloc* in prepetition litigation and settlements. However, time and other circumstances may not permit a prepetition settlement with a certified plaintiff class, and these claims must be dealt with in the prepackaged plan.

Offering claimants some consideration in settlement under the prepackaged plan requires treating the class as impaired. The class must be solicited and will have the opportunity to reject the plan.ⁿ²⁶ In addition, claimants that no longer hold securities of the company may be difficult to identify for adequate prepetition solicitation. Subject to economic constraints and objections by impaired classes, securities litigation claims may be estimated and discharged or left for resolution in subsequent litigation.ⁿ²⁷

[7] Bank Debt.

Generally, restructurings of bank debt continue to be fully negotiated and based on unanimous consent. Banks may become more willing to restructure on the basis of a class vote in a prepackaged bankruptcy as holdouts become more of a problem in large bank groups, especially those with non-bank participants.

If restructured bank financing includes post-confirmation lending commitments, dissenting lenders cannot be forced to participate.ⁿ²⁸ However, outstanding prepetition debt could be treated separately from commitments to make new advances post-confirmation. In such cases, repayment obligations with respect to the prepetition debt, which would ordinarily require unanimous consent to alter, could be restructured by a class vote under a prepackaged plan.

A restructuring of bank debt that is fully negotiated outside the prepackaged plan can be implemented in one of two ways: either a new bank agreement can be executed prepetition to become effective on consummation of the prepackaged plan and the banks can be treated as unimpaired; or the banks can be treated as impaired and "vote" on the prepackaged plan, including the restructured bank agreement, which has already been agreed to and becomes effective on consummation.

Banks are likely to be reluctant to commit to restructured credit terms with an entity whose financial condition on effectiveness cannot be predicted due to the unknown effect of the intervening prepackaged bankruptcy. Banks may insist on conditioning effectiveness upon the company's meeting certain financial tests at consummation. These tests

would be in addition to the feasibility test under the Bankruptcy Code, and they pose an additional risk to the company at the very end of the process. However, a bank group, unlike the holders of public securities, would be in a position to waive such conditions in a timely fashion when deemed appropriate.

[8] Third Party Releases.

The bankruptcy discharge, once granted, forever enjoins a creditor from seeking from the debtor any recovery in respect of its claims, except as provided for in the plan.ⁿ²⁹ The discharge does not, however, have the same effect on possible third party sources of recovery.ⁿ³⁰ Accordingly, creditors may seek to collect deficiency or other additional claims from officers and directors of the debtor, or from other third parties. These tactics frequently are grounded in theories of breach of fiduciary duty (as with many securities litigation claims) or statutory interpretation (as with claims for payment of wages under some state laws). As a result, reorganization plans often contain release and exculpation provisionsⁿ³¹ that purport to inure to the benefit of these third parties. However, the validity of such provisions is a matter of significant dispute, and the likelihood of procuring court approval of such provisions appears to vary considerably from jurisdiction to jurisdiction.

Section 524(e) of the Bankruptcy Code provides that the discharge of a debt of the debtor will not affect the liability of any third party in respect of that debt, but it does not expressly prohibit the release of third-party liabilities as a part of a plan of reorganization.ⁿ³² Several circuit courts have adopted the view that Section 524(e) does not create a per se rule barring the inclusion of third-party releases.ⁿ³³ However, in order to be approved, plan proponents must make substantial factual showings in support of such releases.ⁿ³⁴ Courts in other jurisdictions have taken an even less accommodating view, holding that a bankruptcy court simply lacks the power to issue permanent releases and injunctions for the benefit of non-debtor third parties.ⁿ³⁵

Release provisions may be structured to operate solely as a contractual matter between the third-party releasees and the voting parties who affirmatively elect to approve the releases. There can be no assurance, however, that such provisions will not be successfully challenged.ⁿ³⁶

FOOTNOTES:

(n1)Footnote 1. Similarly, an entity might be party to certain types of burdensome contracts or leases that can be advantageously terminated in a chapter 11 case, *see P 6.05[5] infra*, or have a variety of disputed, contingent, or unliquidated liabilities that can be expeditiously resolved in a chapter 11 case, *see P 6.05[4] infra*. However, these matters generally require litigation in the chapter 11 case and this introduces additional delays, costs and uncertainty.

(n2)Footnote 2. The bankruptcy court may have the power under *section 105 of the Bankruptcy Code* to enjoin actions on the guarantee of a nondebtor guarantor. Such an injunction can best be justified when the action against the nondebtor would adversely affect the debtor, as when the debtor is financially dependent upon the nondebtor. *See Lahman Mfg. Co. v. First Nat'l Bank of Aberdeen (In re Lahman Mfg. Co.)*, 9 C.B.C.2d 621, 33 B.R. 681 (Bankr. D.S.D. 1983) (bank preliminarily enjoined from action on personal guarantees of nondebtor officers and shareholders of corporate debtor that would eliminate funding for reorganization); *Mahaffey v. E-C-P of Arizona, Inc.*, 40 B.R. 469, 473 (Bankr. D. Colo. 1984) (injunction denied where guarantor was not a stockholder and there was no evidence of his intention to contribute funds to a plan). *But see TRS, Inc. v. Peterson Grain & Brokerage Co. (In re TRS, Inc.)*, 76 B.R. 805, 808-09 (Bankr. D. Kan. 1987) ("irreparable injury" requirement for protecting non-debtor guarantor should be based on all the facts, not just on whether guarantor is contributing assets to the reorganization).

(n3)Footnote 3. *See P 9.08[7] infra*.

(n4)Footnote 4. *See P 6.06[2] infra*.

(n5)Footnote 5. *See P 1.09[1][b] supra* for a description of the elements of a plan.

(n6)Footnote 6. For example, the company's charter must be amended pursuant to the plan to prohibit the issuance of non-voting equity securities. *11 U.S.C. § 1123(a)(6)*.

(n7)Footnote 7. To be confirmed, a plan must comply with all applicable provisions of the Bankruptcy Code. *11 U.S.C. § 1129(a)(1)*.

(n8)Footnote 8. *11 U.S.C. § 1123(a)*.

(n9)Footnote 9. *11 U.S.C. § 1122(a)*.

(n10)Footnote 10. *11 U.S.C. § 1123(a)(4)*.

(n11)Footnote 11. This is the requirement that the plan not "discriminate unfairly" with respect to any impaired class that has not accepted the plan. *See 11 U.S.C. § 1129(b)(1)*. In other words, a class may consent to a treatment less favorable than that afforded to a substantially similar class. The issue of unfair discrimination arises only when confirmation is sought in a "cramdown" of a dissenting class. *See P 1.09[3][c] supra* and *P 6.08[3] infra*.

(n12)Footnote 12. This is the requirement that the plan be in "the best interests" of creditors. *11 U.S.C. § 1129(a)(7)*.

(n13)Footnote 13. For the SEC's views on valuations in disclosure materials subject to the 1933 Act and 1934 Act, *see Regulation S-K, Item 10, 17 C.F.R. § 229.10; Rule 175, 17 C.F.R. § 230.175*.

(n14)Footnote 14. *11 U.S.C. § 1129(a)(11)*.

(n15)Footnote 15. *See P 1.09[3][c] supra* and *P 6.08[3] infra* for a discussion of the requirements of a cramdown of a dissenting class.

(n16)Footnote 16. *11 U.S.C. § 1124*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n17)Footnote 17. *11 U.S.C. § 365(b)(2)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n18)Footnote 18. *11 U.S.C. § 1124*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n19)Footnote 19. *See In re Wheeling-Pittsburgh Steel Corp.*, 123 B.R. 18, 21 (Bankr. W.D. Pa. 1990) (finding that while an outcome in which the maximum recovery was granted to the holder of a contingent claim "might force a revision in the reorganized Debtor's operations ... [it] would not require further reorganization or impair consummation of the confirmed Plan."); *In re Pizza of Haw., Inc.* 761 F.2d 1374, 12 C.B.C.2d 1277 (9th Cir. 1985) (possibility of large judgment in pending civil action against debtor calls feasibility into question).

(n20)Footnote 20. *11 U.S.C. § 502(c)*. The bankruptcy court may not have the power to liquidate personal injury and wrongful death claims for the purpose of determining distributions in respect of such claims under a plan. *See 28 U.S.C. § 157(b)(5)*.

(n21)Footnote 21. *11 U.S.C. § 365(g)*. Pursuant to section 365(g), with certain exceptions, rejection of an executory contract or an unexpired lease constitutes a breach of such contract or lease.

(n22)Footnote 22. *See P 6.05[4] supra.*

(n23)Footnote 23. *See id.*

(n24)Footnote 24. *11 U.S.C. § 502(b)(7).* The limitation does not apply to claims under employment contracts in respect of retiree benefits. *11 U.S.C. § 1114(j).*

(n25)Footnote 25. *See 11 U.S.C. § 502(b)(6).*

The two calculations of the cap for lease rejection damages (the "one year" calculation versus the "15%" calculation) are best explained by way of example. Assume the debtor rejects 2 non-residential property leases. Both leases call for fixed annual rent payments of \$100 and are otherwise identical, except that Lease A expires in 5 years, while Lease B expires in 20 years. Under the "one year" calculation, rejection damages for Lease A would equal \$100 (one year of rent), while under the "15%" calculation, the Lease A damages would equal \$75 ($0.15 * \$100 * 5 \text{ years} = \$75$). Clearly, the lessor under Lease A benefits more from the "one year" calculation.

For Lease B, the opposite is true. Under the "one year" calculation, rejection damages are capped at \$100 (the same as for Lease A), while under the "15%" calculation, the lessor's claim is for \$300 ($0.15 * \$100 * 20 \text{ years} = \$300$). Note, however, that if the remaining term under Lease B was 21 years (or more), the lessor would not be entitled to any additional benefit, since in no event can the capped portion of its claim exceed the value of 3 years' rent (in this case, $3 * \$100 = \$300$).

(n26)Footnote 26. The Bankruptcy Code provides some leverage over claims of this sort, which are statutorily subordinated to claims in respect of the underlying security, unless such security is common stock, in which case the litigation claims have an equal priority. *11 U.S.C. § 510(b).*

(n27)Footnote 27. *See P 6.05[4] supra.* Even when a prepetition settlement can be concluded, it may not be a final solution to the extent that class members "opt out." Opt outs do not participate in, and are not bound by, the settlement. However, their claims, because fewer in number, are likely to be more readily dealt with than the claims of the entire class through estimation in the chapter 11 case or resolution in post-confirmation litigation.

(n28)Footnote 28. To the extent commitments to make future advances are contained in prepetition lending documents, such commitments constitute an executory contract to make a loan that cannot be assumed by the debtor. *11 U.S.C. § 365(c)(2).* A new contractual undertaking of a lending group to make post-confirmation advances as part of a negotiated restructuring plan cannot be imposed on a dissenting member as a matter of contract law.

(n29)Footnote 29. *See 11 U.S.C. §§ 524(a), 1141*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n30)Footnote 30. *See 11 U.S.C. § 524(e).*

(n31)Footnote 31. Plans frequently contain separate sections providing for court-ordered third-party releases (purporting to release claims against third parties) and court-ordered exculpation of third parties (finding and determining that certain third parties have no liability for certain acts). As a practical matter, the legal effect of these provisions often is indistinguishable. In jurisdictions that generally permit such third party protections, the exculpation provisions are supposed to be a simple statement of the law that does not confer additional protections on the exculpated party. *See, e.g., In re PWS Holding Corp.*, 228 F.3d 224, 246 2000 U.S. App. LEXIS 23393, 44 C.B.C.2d1647 (3d Cir. 2000). However, even the form of exculpation that was approved in the *PWS Holding* case (the so-called "Bruno's release") protected whole categories of agents, advisors, professionals and employees that might not otherwise have been entitled to such protections. *Id.*

(n32)Footnote 32. 11 U.S.C. § 524(e).

(n33)Footnote 33. See *In re PWS Holding Corp.*, 228 F.3d 224, 2000 U.S. App. LEXIS 23393, 44 C.B.C.2d 1647 (3d Cir. 2000) ; *Gillman v. Continental Airlines (In re Continental Airlines, Inc.)*, 203 F.3d 203, 211-14, 2000 U.S. App. LEXIS 1263 (3d Cir. 2000) (surveying case law regarding third-party releases in other circuits, but declining to establish a "blanket rule"); *Munford v. Munford, Inc. (In re Munford, Inc.)*, 97 F.3d 449 ; 36 C.B.C.2d 1604, 1996 U.S. App. LEXIS 26466 (11th Cir. 1996) ; *In re Drexel Burnham Lambert Group*, 960 F.2d 285, 293, 26 C.B.C.2d 1413, 1992 U.S. App. LEXIS 5513 (2d Cir. 1992) ("a [bankruptcy] court may enjoin a creditor from suing a third party, provided the injunction plays an important part in the debtor's reorganization plan"); *In re Metromedia Fiber Network, Inc.* 416 F.3d 136 (2d Cir. 2005) (release of nondebtors is appropriate only in rare cases); *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694, 702 (4th Cir. 1989) (section 524(e) does not limit equitable powers of bankruptcy court to enjoin permanently actions against third parties that could give rise to indemnity or contribution claims against the debtor and threaten reorganization), *cert. denied*, 493 U.S. 959, 110 S. Ct. 376, 107 L. Ed. 2d 362 (1989) ; see also *LTV Corp. v. Back (In re Chateaugay Corp.)*, 36 C.B.C.2d 1488, 201 B.R. 48, 1996 Bankr. LEXIS 1232 (Bankr. S.D.N.Y. 1996) (citing § 105(a) as a basis to release a non-debtor from liability to third parties where such a step was necessary to prevent collateral attack from undermining plan and the integrity of the chapter 11 process); *In re Dow Corning Corp.*, 255 B.R. 445, 479 2000 U.S. Dist. LEXIS 16385 (E.D. Mich. 2000) (concluding that the Bankruptcy Court can exercise its equitable powers under § 105(a) to issue permanent injunctions where "unusual circumstances" are present).

(n34)Footnote 34. See, e.g., *Class Five Nev. Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 47 C.B.C.2d 1158 (6th Cir. 2002) (holding that the bankruptcy court can enjoin a creditor's claims against a non-debtor third party only in "unusual circumstances," when the following factors are present: (1) an "identity of interests" between the debtor and the third party, such as an indemnity relationship; (2) the third party has contributed substantial assets to the reorganization; (3) the injunction is essential to reorganization; (4) a large majority of the impacted class or classes of creditors has voted to accept the plan; (5) the plan provides for payment of all, or substantially all, of the claims affected by the injunction; (6) the plan provides an opportunity for those claimants who choose not to settle to recover in full and; (7) the court makes a record of specific factual findings that support its conclusions); *In re Seatco, Inc.*, 45 C.B.C.2d 716, 257 B.R. 469, 474, 2001 Bankr. LEXIS 24 (Bankr. N.D. Tex., 2001) (citing *In re Master Mortgage Inv. Fund*, 168 B.R. 930, 935 (Bankr. W.D. Mo. 1994)) ; see also *In re American Family Enters.*, 256 B.R. 377 (D.N.J. 2000) (granting a permanent injunction in favor of a non-debtor because the debtor satisfied the five factors enumerated in *In re Master Mortgage*).

(n35)Footnote 35. *Resorts Int'l v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401, 34 C.B.C.2d 544, 1995 U.S. App. LEXIS 28027 (9th Cir. 1995) , *cert. denied*, 517 U.S. 1243, 116 S. Ct. 2497, 135 L. Ed. 2d 189 (1996) ("This court has repeatedly held, without exception, that § 524(e) precludes bankruptcy courts from discharging the liabilities of non-debtors."); *Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746 ; 1995 U.S. App. LEXIS 25272 (5th Cir. 1995) (temporary stay of claims against third parties may be necessary to facilitate a debtor's reorganization, but permanent injunction of creditor claims against third parties is improper); *In re Western Real Estate Fund, Inc.*, 922 F.2d 592, 601-02, 1990 U.S. App. LEXIS 22383, 24 C.B.C.2d (MB) 1012 (10th Cir., 1990) (same), *modified by*, *Abel v. West*, 932 F.2d 898 (10th Cir. 1991) .

(n36)Footnote 36. See *In re AOV Indus., Inc.*, 792 F.2d 1140 (D.C. Cir. 1986) (bankruptcy court had jurisdiction to approve a plan of reorganization pursuant to which certain third parties made available funds for distribution to unsecured creditors of the debtor who tendered releases of such third parties from certain liabilities); *In re Specialty Equip. Cos., Inc.*, 3 F.3d 1043 (7th Cir. 1993) (provisions of confirmed plan bind all creditors regardless of whether a particular creditor voted to accept plan.). But see *In re Arrowmill Dev. Corp.*, 38 C.B.C.2d 938, 211 B.R. 497 (Bankr. D.N.J. 1997) (validity of a release of a nondebtor's liability hinges upon principles of straight contract law or quasi-contract law, rather than upon the bankruptcy court's confirmation order); *In re Digital Impact, Inc.*, 223 B.R. 1 (Bankr. N.D. Okla. 1998) (plan may not be confirmed if any party who would be bound by the release did not vote in favor of the plan); *In re Zenith Elecs. Corp.*, 241 B.R. 92, 111 (Bankr. D. Del. 1999) (releases of non-derivative third-party claims against nondebtor require the affirmative agreement of the creditor affected).



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CHAPTER 6 Prepackaged Bankruptcies

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P 6.06 Financing a Prepackaged Bankruptcy.

[1] Overview.

The use of a prepackaged bankruptcy creates special financing problems that must be addressed by the restructuring company. For planning purposes, the restructuring under a prepackaged bankruptcy can be divided into three phases.

The first phase is the period prior to the commencement of the prepackaged bankruptcy when the prepackaged plan is negotiated and acceptances are solicited. The problems of maintaining operating liquidity during this period are discussed above.ⁿ¹

The company enters the second phase once the prepackaged bankruptcy has commenced. The company may now take advantage of the special inducements provided under *section 364 of the Bankruptcy Code* to obtain DIP financing to meet its working capital needs during the prepackaged bankruptcy. DIP financing arrangements can be complicated and raise serious issues for and among prepetition creditor groups. Consequently, they should be planned for and negotiated well in advance of the prepackaged bankruptcy.ⁿ²

The third and final phase begins with consummation of the prepackaged plan. At this point the company must be prepared to refinance any outstanding DIP loans, make any other confirmation payments and provide for the ongoing working capital needs of post-confirmation operations.

[2] DIP Financing.

A company in the process of restructuring may need financing during its prepackaged bankruptcy. Even though suppliers who give deferred payment terms on goods and services provided postpetition have a priority over all prepetition unsecured claims,ⁿ³ there may still be a reluctance to give credit terms because of doubts about the company's ability to generate sufficient cash flow from operations to meet all postpetition obligations. The availability of outside financing may be necessary to induce suppliers to give deferred payment terms or, to the extent not successful in this regard, to meet cash on delivery terms.

[a] Bankruptcy Code Provisions.

Section 364 of the Bankruptcy Code provides a stepped series of inducements to postpetition lenders, the top flight of

which is the superpriority right of payment and the senior, or "priming," lien on property of the restructuring company.ⁿ⁴

The grant of a priming lien under *section 364(d) of the Bankruptcy Code* is conditioned upon a showing that there is "adequate protection" of the interest of the prepetition secured party.ⁿ⁵ Generally, there is adequate protection when the value of the property subject to the existing lien is sufficient to secure fully the original obligation and any obligation to be secured by the priming lien. In the absence of such an "equity cushion," some action is required to compensate the original secured party for any decrease in the value of its interest in the encumbered property that results from the imposition of the priming lien.ⁿ⁶ The secured status of any prepetition creditor seeking adequate protection and valuation of the property in which a security interest is claimed are critical issues in the approval of any postpetition financing that is to be secured by priming liens granted under section 364(d).

[b] Prefiling Preparations.

In seeking DIP financing, the company should take all the steps it can to ensure that the arrangements negotiated will be approved by the bankruptcy court and to reduce the likelihood that they will be challenged by its creditors. Principally, this requires (i) establishing an evidentiary record that financing was not available from the proposed or other sources on substantially better terms; and, (ii) to the extent possible, avoiding provisions that have the effect of altering the relative positions of prepetition creditors prior to confirmation.

[i] Selecting Postpetition Lenders.

A postpetition lender may be afforded one of the stepped levels of priority under *section 364 of the Bankruptcy Code* only if the company is unable to obtain financing at a lesser level of priority.ⁿ⁷ It is also common for bankruptcy courts to require some showing that other key provisions of proposed DIP financing, such as pricing and covenants, are competitive. Accordingly, in seeking postpetition lenders, the company and its financial advisor should make inquiries of a number of sources as to willingness to provide DIP financing and on what terms.ⁿ⁸

As a rule, existing lenders are to be preferred to third parties as postpetition lenders in a prepackaged bankruptcy. Existing lenders will have a familiarity with the company, its assets and operations, as well as an established covenant structure that reflects this understanding. This will allow for a speedier and more cost-efficient completion of negotiations and documentation.ⁿ⁹ More importantly, perhaps, for a prepackaged bankruptcy, the introduction of a third-party lender could occasion serious disputes with existing lenders that might put into doubt the ultimate approval of the proposed DIP financing. Existing lenders are likely to see the superpriority and priming liens of a third-party as a threat to prepetition recoveries.

However, many prepetition lenders, especially where exposure is relatively small, may be reluctant to commit new money to an already troubled situation. If prepetition lenders are unwilling to provide DIP financing or to do so on competitive terms, the company must be prepared to seek DIP financing from other sources. It would then be desirable to take whatever steps possible prior to the commencement of the prepackaged bankruptcy to ensure that the prepetition lenders do not object to the terms of the DIP financing. These will include negotiations with both sets of lenders.

[ii] Negotiations: Avoiding Volatile Issues.

It is not uncommon for existing lenders providing DIP financing to seek cash payments or other accommodations as adequate protection for prepetition security interests, cross-collateralization of prepetition claims with postpetition collateral, affirmation of the validity of prepetition liens, the release by the debtor of fraudulent conveyance, preference or other claims against such lenders or a lien on the proceeds of such actions against other creditors. These measures may go to the heart of what are often disputed issues underlying a restructuring agreement.

In negotiating DIP financing arrangements, the parties should be sensitive to the fact that the prepackaged plan may represent a settlement of litigable issues among the restructuring creditor groups. Steps by one impaired class to improve significantly its relative position prior to the confirmation of the prepackaged plan may be contested by other impaired classes, which could be disruptive to the prepackaged bankruptcy.

[iii] Contingency Plans.

The company must be prepared for the possibility that a premature filing may be required and that it will not be able to pursue a true prepackaged bankruptcy. Nonetheless, the company may require DIP financing during the chapter 11 case and should negotiate with its postpetition lenders for financing in such circumstances. However, prospective postpetition lenders willing to provide financing in a prepackaged bankruptcy may not be willing to finance a non-prepackaged bankruptcy.

[3] Financing Confirmation Payments and Post-Confirmation Operations.

Coming out of a chapter 11 case may entail significant cash demands, such as repaying outstanding DIP loans, cashing out estimated claims, curing defaults under assumed executory contracts, paying interest accrued during the proceeding on oversecured debt and paying accrued professional fees. In addition, the company will need liquidity for post-confirmation operations. It will be important for the company to get an adequate understanding of all these cash requirements as early as possible, so that they may be addressed in negotiations.

FOOTNOTES:

(n1)Footnote 1. *See P 6.04[2][a] supra.*

(n2)Footnote 2. *See P 9.08[6][b] infra.* In addition, early assurances in this regard may help in maintaining operations during the negotiation and solicitation of votes on a prepackaged plan.

(n3)Footnote 3. Unsecured debt incurred in the ordinary course of business, such as trade debt, is allowable as an administrative expense under section 503(b)(1). *11 U.S.C. § 364(a).*

(n4)Footnote 4. *11 U.S.C. § 364. See P 1.06[2] supra* for a description of these provisions.

(n5)Footnote 5. *11 U.S.C. § 364(d)(1)(B).*

(n6)Footnote 6. Such action may take the form of (i) a cash payment or periodic cash payments; (ii) a substitute lien; or (iii) such other relief as may be appropriate. *11 U.S.C. § 361.*

(n7)Footnote 7. *11 U.S.C. § 364(c), (d)(1)(A).*

(n8)Footnote 8. There are no precise guidelines to the extent of the inquiries that should be made. While there is no requirement that the company must exhaust all possible sources, it is advisable that a number of alternatives be explored.

(n9)Footnote 9. In addition, in light of their prepetition investment, existing lenders are likely to be more flexible in a default situation under the DIP financing and more inclined to give the restructuring the benefit of the doubt.



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CHAPTER 6 Prepackaged Bankruptcies

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P 6.07 Solicitation: Disclosure and Procedures.

[1] Overview.

The solicitation of votes is a crucial phase of a restructuring employing a prepackaged chapter 11. In the case of a true prepackaged chapter 11, the company commences its case only after it has received acceptances that it determines to be sufficient in number and amount to confirm the prepackaged plan. However, after the chapter 11 case has been commenced, the bankruptcy court may disregard prepetition votes that it determines to have been improperly solicited.ⁿ¹ Invalidation of the prepetition solicitation would undermine the two fundamental premises of the prepackaged chapter 11, namely, that it will be a short proceeding and that it may be conducted on the presumption that the prepackaged plan will be confirmed.

A resolicitation conducted postpetition would be subject to *section 1125(b) of the Bankruptcy Code*, which requires the prior approval by the bankruptcy court of the disclosure statement used in such solicitation.ⁿ² This process can substantially lengthen the chapter 11 case.ⁿ³ In addition, the company is subjected to further uncertainty as to the outcome of the resolicitation.

There are two aspects to the prepetition solicitation process that must be given careful attention to minimize the risk of subsequent challenge: (i) the nature of the disclosure made in connection with the solicitation and (ii) the procedures followed in making such solicitation. The Bankruptcy Code does not give definitive guidance with respect to either aspect in the case of a prepackaged chapter 11.ⁿ⁴

[2] Disclosure.

A disclosure statement used in a prepetition solicitation must comply with "any applicable nonbankruptcy law, rule or regulation governing the adequacy of disclosure in connection with such solicitation."ⁿ⁵ Only if there is no applicable nonbankruptcy law must the solicitation be based on the standard of "adequate information"ⁿ⁶ provided in *section 1125 of the Bankruptcy Code* and generally applicable to postpetition solicitations.ⁿ⁷

In solicitations of public debt, the applicable non-bankruptcy law governing disclosure will be the federal securities laws and state blue sky laws.ⁿ⁸ The solicitation of votes on a prepackaged plan pursuant to which new securities of the restructuring company will supersede some or all of its outstanding securities constitutes an "offer to sell" such new securities, which, absent an available exemption,ⁿ⁹ would be subject to the registration and disclosure requirements of

the 1933 Act.ⁿ¹⁰

There are two principal benefits to an exempt solicitation. First, time will be saved by the elimination of SEC review. Second, the prepackaged plan may be fully negotiated with creditor groups before it is publicly announced. However, without prepetition SEC review, the disclosure document may be subject to more rigorous review in the chapter 11 disclosure hearing.ⁿ¹¹

Whether or not exempt under the 1933 Act, a prepetition solicitation in connection with a prepackaged plan may also be subject to the proxy rulesⁿ¹² and the going private rulesⁿ¹³ of the 1934 Act. The proxy rules prescribe disclosure requirements substantially similar to those under the 1933 Act, while the going private rules provide additional disclosure requirements.

[3] Procedures.

Federal Rule of Bankruptcy Procedure 3018(b) sets forth certain minimum procedural requirements to be followed in the solicitation of acceptances of a prepackaged plan.

[a] Record Holders and Beneficial Owners.

Most publicly traded securities are held of record by clearing house nominees on behalf of brokers, dealers, banks and other financial institutions participating in the clearing house system. These participants may own some securities for their own account and hold others on behalf of customers. In connection with a securities vote, the clearing house nominee conveys voting authority to the participants by an omnibus proxy; participants then vote as instructed by their customers. The proxy rules recognize this structure, and the registrant is not obligated to provide materials in connection with a proxy solicitation directly to the beneficial owners of its securities, but only to the brokers, dealers and other nominees for such owners.ⁿ¹⁴ The nominees must promptly forward these solicitation materials to their customers, the beneficial owners.ⁿ¹⁵

Federal Rule of Bankruptcy Procedure 3018(b) requires that votes in respect of debt and equity securities that are held of record be obtained from the *record holders* as of a date specified in the solicitation. This requirement, although consistent with the nonbankruptcy securities laws and practice described above, was rejected by the bankruptcy court in *In re Southland Corp.*, which then went on to invalidate Southland's prepetition solicitation made in compliance with the rule.ⁿ¹⁶ Southland solicited votes on its prepackaged plan from the record holders of its securities (or, when the record holder was a clearing house nominee, from the clearing house participants). The *Southland* court, however, ruled that under *section 1126 of the Bankruptcy Code*, only beneficial owners of securities may vote on a plan, and that references to "record holders" in *Federal Rule of Bankruptcy Procedure 3018(b)* are impermissible substantive changes to the Bankruptcy Code that are of no effect.ⁿ¹⁷ The court invalidated all acceptances received from record holders or participants that were not beneficial owners or who could not be established as the authorized agents of the beneficial owners.ⁿ¹⁸

Several courts have since adopted the *Southland* court's ruling that votes must be solicited from beneficial, not record, owners of securities being restructured.ⁿ¹⁹ Consequently, solicitations must be structured to satisfy both the beneficial owner based requirements of *Southland* and the record holder based requirements of *Bankruptcy Rule 3018(b)*. In its bankruptcy case, JPS Textiles Group, Inc. stipulated that acceptance or rejection of its prepackaged plan would be based on the votes of beneficial owners.ⁿ²⁰ Its prepetition solicitation was made to the record holders of its securities, but using a procedure to account for beneficial owner votes. Ballots were supplied for nominees to pass through to beneficial owners. These ballots included a certification from the beneficial owner as to any securities voted under other accounts with the same or any other nominee identified by principal amount and account number. On completion, these were returned to the nominees who, either as record holders or under authority from a record holder, completed "master ballots," reporting beneficial owner votes by customer account number and principal amount. In addition, the master

ballots reported information received on beneficial owner ballots as to additional securities voted. Under this procedure, votes "cast" by record holders can be accurately identified to beneficial owners while preserving confidentiality.

[b] Dissemination.

The prepackaged plan must be transmitted to substantially all creditors and stockholders in each impaired class. If substantially all holders in a given impaired class did not receive the solicitation materials, any votes actually received from holders in that class may be invalidated.ⁿ²¹ In addition, if the conduct of parties who are not creditors or equity security holders of the debtor would be enjoined by the plan, then efforts must also be made to provide such parties with copies of the plan and disclosure statement, and an opportunity to object to the plan.ⁿ²²

[c] Solicitation Period.

With respect to a prepetition solicitation, the only requirement under bankruptcy law is that the solicitation period not be "unreasonably short."ⁿ²³ The period for a postpetition solicitation is fixed on a case-by-case basis and, therefore, offers no guideline.ⁿ²⁴ The minimum period of twenty business days during which a tender offer must be held open may be a useful guide, although it is in no way determinative.ⁿ²⁵ If a holder of a claim or interest was solicited before the commencement of the case in a manner complying with applicable nonbankruptcy law, then an acceptance or rejection of the plan may be solicited from such holder postpetition if such solicitation also complies with applicable nonbankruptcy law.ⁿ²⁶

Southland first introduced its prepackaged plan as an amendment to an exchange offer in progress. Southland held the solicitation period open for ten business days, the period required in connection with an amendment to an exchange offer.ⁿ²⁷ The SEC advised the *Southland* bankruptcy court that the ten-day period would have been sufficient in respect of a decision to *tender* into the exchange offer.ⁿ²⁸ It would not comment as to whether such period was sufficient for a decision to *vote* on the prepackaged plan. In the SEC's view, this was not a question addressed by the securities laws.ⁿ²⁹ The bankruptcy court ruled that the period was unreasonably short under *Federal Rule of Bankruptcy Procedure 3018(b)* and invalidated *all* prepetition acceptances.ⁿ³⁰

[d] Withdrawal of Votes.

The Bankruptcy Code is silent on prepetition withdrawals of votes on a prepackaged plan. Once the prepackaged chapter 11 case has been commenced, however, it appears that a vote may be changed or withdrawn only with approval of the court.ⁿ³¹ In this regard, the proxy rules provide that disclosure must be made as to whether and to what extent the proxy sought is revocable.ⁿ³²

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 1126(b); Fed. R. Bankr. P. 3018(b)*.

(n2)Footnote 2. *11 U.S.C. § 1125(b)*. However, in the case of a small business debtor (*see 11 U.S.C. § 101(51C)* for the definition of "small business"), in addition to other options, the court may conditionally approve a disclosure statement subject to final approval after notice and a hearing, and acceptances or rejections of a plan may be solicited based on the conditionally approved disclosure statement as long as the debtor provides adequate information to each holder of a claim or interest that is solicited. *11 U.S.C. § 1125(f)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n3)Footnote 3. At least twenty-five days' notice to parties in interest is required for a hearing to consider approval of a disclosure statement. *Fed R. Bankr. P. 2002(b)* and *3017(a)*. A further period for resolicitation would follow the disclosure hearing. In the case of a true prepackaged bankruptcy, a hearing on the disclosure statement would still be required upon statutory notice. However, the solicitation would already have been completed and the disclosure

statement hearing could be combined with a hearing to confirm the prepackaged plan.

(n4)Footnote 4. In the case of a regular chapter 11 case, the bankruptcy court both determines the adequacy of the disclosure statement and fixes the duration of the solicitation period prior to solicitation, removing two principal areas of uncertainty. *Fed R. Bankr. P. 3017(b), (c)*.

(n5)Footnote 5. *11 U.S.C. § 1126(b)(1)*.

(n6)Footnote 6. *11 U.S.C. § 1125(a)(1)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). This is, generally, information of a kind, and in sufficient detail, as would enable a reasonable investor (similarly situated to the typical holder of claims of or interests in the relevant class) to make an informed judgment about the proposed plan. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amends section 1125 to require disclosure of any material federal tax consequences of the proposed plan.

(n7)Footnote 7. *11 U.S.C. § 1126(b)(2)*.

(n8)Footnote 8. It is important to remember that compliance with such laws will bear not only on the determination under the Bankruptcy Code as to the adequacy of disclosure in connection with the prepetition solicitation, but may also be independently required to avoid liability under such non-bankruptcy laws themselves.

(n9)Footnote 9. There are three exemptions from registration. *See P 5.08 supra*. At least one commentator has taken the position that *section 1145 of the Bankruptcy Code* acts to exempt prepetition solicitations in connection with prepackaged plans from these requirements. S. Case & M. Harwood, *Current Issues in Prepackaged Chapter 11 Plans of Reorganization and Using the Federal Declaratory Judgment Act for Instant Reorganizations* 79 (1991) (unpublished monograph). *Section 1145 of the Bankruptcy Code*, with certain exceptions, exempts from section 5 of the 1933 Act the offer and sale of securities pursuant to a plan of reorganization in exchange for claims against, and interests in, the reorganizing issuer. However, neither the Bankruptcy Code nor the 1933 Act gives express guidance as to how to deal with a prepackaged plan, which has two phases: first, a prepetition solicitation, which occurs outside the jurisdiction of the bankruptcy court; and second, confirmation and consummation of the prepackaged plan, including the issuance of new securities, in a prepackaged bankruptcy which is subject to the Bankruptcy Code. It is the position of the SEC staff that prepetition solicitations in respect of a prepackaged plan are subject to the 1933 Act.

(n10)Footnote 10. *See P 5.06[3] supra*. For a discussion of the advantages and disadvantages of registration, as well as a description of the mechanics involved, *see P 5.07 supra*.

(n11)Footnote 11. SEC review does not entail a determination of adequacy under the securities laws of the disclosure contained in the materials reviewed. However, it may not be unreasonable to expect a bankruptcy court to regard unreviewed materials differently from those that have undergone a review, comment, and revision procedure.

(n12)Footnote 12. *See P 5.12[7] supra*.

(n13)Footnote 13. *See P 5.11[4] supra*.

(n14)Footnote 14. *See Rule 14a-13, 17 C.F.R. § 240.14a-13(a)*.

(n15)Footnote 15. *See Rules 14b-1(b) and 14b-2(b), 17 C.F.R. §§ 240.14b-1 and 240.14b-2*. In addition, the registrant must pay the nominees' reasonable expenses of distributing the solicitation materials to the beneficial owners. *Rule 14a-13, 17 C.F.R. § 240.14a-13(a)(5)*.

(n16)Footnote 16. *In re Southland Corp.*, 124 B.R. 211, 1991 Bankr. LEXIS 228 (Bankr. N.D. Tex. 1991) ; *accord In re Pioneer Fin. Corp.*, 43 C.B.C.2d 1536, 246 B.R. 626, 634 (Bankr. D. Nev. 2000) ; *In re City of Colorado Springs*

Spring Creek Gen. Improvement Dist., 177 B.R. 684, 691, 1995 Bankr. LEXIS 115 (Bankr. D. Colo. 1995) (denying confirmation where voting record was ambiguous and solicitation record was inadequate to show that disclosure had been provided to all beneficial holders in a pre-petition solicitation).

(n17)Footnote 17. *In re Southland Corp.*, 124 B.R. 211, 227 (Bankr. N.D. Tex. 1991) .

(n18)Footnote 18. In addition to the issue of voting authority, the *Southland* bankruptcy court found that a record holder based vote raised difficulties for tabulating both the numbers of votes and the dollar amounts voted. *See id. at 222-23* . Each record holder was allotted one vote on behalf of the beneficial owners it represented voting "yes" and one vote on behalf of those voting "no." The votes were not weighted to reflect the underlying beneficial owner vote. *Id. at 222* . Since votes were not identifiable to the particular beneficial owners actually casting them, if a record holder voted more than its record principal amount, the entire dollar amount would be prorated over "yes" and "no" votes. Similarly, when a subsequent ballot was received from a record holder that had already voted, the superseding votes could not accurately be correlated with the votes reflected in the original ballot. *Id. at 223* .

(n19)Footnote 19. *See In re Pioneer Fin. Corp.*, 43 C.B.C.2d 1536, 246 B.R. 626, 634 (Bankr. D. Nev. 2000) ; *In re City of Colorado Springs Spring Creek Gen. Improvement Dist.*, 177 B.R. 684, 691, 1995 Bankr. LEXIS 115 (Bankr. D. Colo. 1995) ; *In re Tenn-Fla Partners*, 1993 Bankr. LEXIS 789 (Bankr. W.D. Tenn. Apr. 29, 1993) . A beneficial owner-based vote raises substantial obstacles to a prepetition solicitation. An effective solicitation and tabulation of beneficial owner votes would have to be based on the customer lists of clearing house participants. Participants, however, have no obligation to disclose the lists and generally treat them as confidential. In *Southland*, these lists were produced pursuant to an order of the court, which provided for confidential treatment. *In re Southland Corp.*, 124 B.R. 211, 227 (Bankr. N.D. Tex. 1991) (Order Directing Participants to Provide Copies of Customer Lists and Mailing Labels of Beneficial Owners of Old Securities, dated Dec. 28, 1990). The balloting approach described in this paragraph, developed in the prepackaged chapter 11 of JPS Textile Group, Inc., attempts to provide for a beneficial owner based vote using the traditional solicitation mechanisms used under the proxy rules.

(n20)Footnote 20. *In re JPS Textiles Gp., Inc.*, No. 91 B 10546 (JAG), Disclosure Statement at 99 (Bankr. S.D.N.Y. Feb. 7, 1991).

(n21)Footnote 21. *Fed. R. Bankr. P. 3017(e), 3018(b)*.

(n22)Footnote 22. *Fed. R. Bankr. P. 3017(f)*. In some cases, the scope of such an injunction will render actual notice to all such parties impracticable. In such cases, the bankruptcy court may order that notice of the disclosure statement hearing be published. *See Fed. R. Bankr. P. 3017(f)*, Advisory Committee Note - 2001 Amendment.

(n23)Footnote 23. *Fed R. Bankr. P. 3018(b)*.

(n24)Footnote 24. *See Fed R. Bankr. P. 3017(c)*.

(n25)Footnote 25. Rule 14e-1(a), 17 C.F.R. § 240.14e-1(a).

(n26)Footnote 26. 11 U.S.C. § 1125(g).

(n27)Footnote 27. Rule 14e-1(b), 17 C.F.R. § 240.14e-1(b).

(n28)Footnote 28. *In re Southland Corp.*, No. 390-37119-HCA-11 (Bankr. N.D. Tex. Oct. 24, 1990) (Response of the Securities and Exchange Commission to the Court's Request for a Statement of Position Regarding Compliance of Debtor's Prepetition Solicitation with Federal Securities Laws, dated Dec. 26, 1990, at 18).

(n29)Footnote 29. *Id. at 19* .

(n30)Footnote 30. *In re Southland Corp.*, 124 B.R. 211, 227 (Bankr. N.D. Tex. 1991) . The Bankruptcy Court of

the Southern District of New York has set the following parameters for a "reasonable" solicitation period: for nonpublicly traded securities, the period is 10 days; for publicly-traded securities and all other claims, the period is 20 days. The Court, in its discretion, may allow shorter solicitation periods where justified. *See In the Matter of the Adoption of Prepackaged Chapter 11 Case Guidelines*, General Order 203, Amending General Order 201, Part VII. A. 1-3. (Bankr. S.D.N.Y. February 24, 1999). For a discussion of General Order 201, *see P 6.08[4] infra*.

(n31)Footnote 31. *See Fed. R. Bankr. P. 3018(a)*.

(n32)Footnote 32. *See Schedule 14A, 17 C.F.R. § 240.14a-101*.



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CHAPTER 6 Prepackaged Bankruptcies

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P 6.08 The Chapter 11 Case.

It must not be overlooked that a prepackaged bankruptcy is a chapter 11 case that is governed by the Bankruptcy Code and Bankruptcy Rules.

[1] Prefiling Preparation.

The company needs to be in a position to commence the prepackaged chapter 11 case *immediately* upon expiration of the solicitation period or any extension needed to obtain the required acceptances. It may also be necessary to commence a partially prepackaged chapter 11 case on shorter notice if the situation suddenly deteriorates. In addition to preparing petition papers (including lists, schedules and statements), motions for various first-day orders essential to minimizing disruption of operations must be prepared (*e.g.*, cash management, DIP financing, payment of employee wages and extension of time to file schedules).ⁿ¹ To the extent the significant items of first day relief can be identified sufficiently in advance, it may be useful to describe these in the disclosure materials. This will both assist the company in identifying in advance of the related hearing any creditor objections to the proposed relief and, to the extent no objections are raised, give support to the request for relief. In addition, prefiling conferences with the clerk of the bankruptcy court and the United States trustee may be advisable.ⁿ²

[2] Case Administration.

The chapter 11 case could involve substantial procedural and substantive matters in connection with and in addition to the confirmation of the prepackaged plan depending upon the extent to which issues with any individual or group have been left unresolved at the commencement of the chapter 11 case. These include the appointment of a creditors' committee,ⁿ³ the retention of counsel, financial advisorsⁿ⁴ and other professionals,ⁿ⁵ and hearings to approve the prepetition disclosure statementⁿ⁶ and confirm the prepackaged plan.ⁿ⁷ In addition, a variety of unanticipated matters could arise that would need to be addressed: for example, motions to compel the company to assume or reject particular executory contracts prior to confirmation of the plan,ⁿ⁸ or motions for relief from the automatic stay to press various litigation claims or foreclosure actions.ⁿ⁹

Many of these matters may be disposed of by so-called "First Day Orders." For example, in the Southern District of New York, General Order 201 provides, among other things, forms and guidelines for making motions to address these matters and other administrative matters.ⁿ¹⁰

The company may choose to simplify administration of the chapter 11 case by the elimination of a "bar date," a deadline usually set for the filing of proofs of claims against a debtor.ⁿ¹¹ Ordinarily, the bar date is used to identify creditors and to determine the scope of liabilities. However, in the case of a prepackaged chapter 11, especially when the impaired classes are confined to holders of debt and equity securities, the holders of the impaired claims and interests are known and the amounts of their claims and interests are not in dispute.ⁿ¹²

[3] Confirmation.

After the first day hearing on the initial orders for relief, the most significant proceeding in the chapter 11 case should be the hearing, or hearings, to approve the prepetition disclosure statement and confirm the prepackaged plan.ⁿ¹³

To approve the disclosure statement, the bankruptcy court must determine that the disclosure complies with *section 1126(b) of the Bankruptcy Code*. In the case of a solicitation of public securities, this will generally mean compliance with the 1933 Act and 1934 Act.ⁿ¹⁴ Prepetition review of disclosure documents by the SEC should make a challenge to disclosure more difficult. However, the bankruptcy court may have its own views as to the disclosure required by the materiality standards of the federal securities laws in connection with a reorganization in bankruptcy.ⁿ¹⁵

To confirm the prepackaged plan, the bankruptcy court must determine that all of the requirements of section 1129(a) are met.ⁿ¹⁶ Any party in interest, whether or not impaired under the plan, may object to confirmation.ⁿ¹⁷ The principal matters at issue, besides the receipt of the requisite votes, are the satisfaction of the best interests test and the determination of feasibility.ⁿ¹⁸

If an impaired class has not accepted the prepackaged plan, the company, as proponent of the plan, may still move for its confirmation in a "cramdown" of the dissenting class, provided that certain requirements are met.ⁿ¹⁹ These include the requirements that at least one impaired class shall have accepted the planⁿ²⁰ and that the plan does not "discriminate unfairly" againstⁿ²¹ and is "fair and equitable" toⁿ²² the dissenting class. The essential feature of the "fair and equitable" test is the adherence to "absolute priorities," that is, the members of the dissenting class are entitled to be paid in full before any junior class receives or retains any property under the plan.ⁿ²³ Confirmation in such circumstances will almost certainly be contested and will turn largely on valuation issues. General Order 201 of the Bankruptcy Court of the Southern District of New York clarifies what constitutes a rejection of the prepackaged plan for purposes of a cramdown. General Order 201 applies the cramdown principle not only to classes that have voted to reject the plan and to classes that are deemed to reject the plan pursuant to *section 1126(g) of the Bankruptcy Code* because they receive no distribution under the plan, but also to impaired classes, whose votes are not solicited by the debtor, that are deemed to reject the plan because they receive only a nominal distribution under the plan. General Order 201 thereby allows a debtor not to solicit votes of an impaired class receiving a nominal distribution under a plan.ⁿ²⁴

[4] Guidelines of the Bankruptcy Court of the Southern District of New York.

The Bankruptcy Court of the Southern District of New York adopted General Order 201 on February 2, 1999. General Order 201 was amended slightly by General Order 203 on February 24, 1999 (collectively, the "General Order") and formally adopted into the local rules of that district effective August 2, 2004.ⁿ²⁵ The General Order seeks to resolve some of the many substantive and procedural difficulties that have plagued prepackaged chapter 11 cases, as chronicled in this chapter and elsewhere. First, it establishes guidelines for commencing and administering prepackaged bankruptcies in the U.S. Bankruptcy Court for the Southern District of New York. Second, it provides forms for the prepackaged scheduling motion, ballots for voting on the plan and the summary of the plan. (While use of these forms is optional, they should increase the efficiency of the prepackaged bankruptcy process in the Southern District of New York.) Finally, the General Order provides instructions for filing the case electronically.

Although the General Order is an important step in developing clearer procedures for administering a prepackaged bankruptcy, it is important to realize that it consists of advisory guidelines only, and is not binding on the bankruptcy

court. Furthermore, its applicability beyond the borders of the Southern District of New York is analogical at best. Nevertheless, the General Order covers several important areas in the preparation and actual filing of a prepackaged chapter 11 case. Equally important, the General Order serves as an acknowledgment of (and provides an additional layer of legitimacy to) both full and partial prepackaged bankruptcies.

[a] Definitions.

The General Order defines a "prepackaged Chapter 11 case" as "one in which the Debtor, substantially contemporaneously with the filing of its Chapter 11 petition, files a Confirmation Hearing Scheduling Motion For Prepackaged Plan ..., [the] plan, disclosure statement (or other solicitation document), and voting certification."ⁿ²⁶

The General Order is not limited to "full" prepackaged bankruptcies. It expressly notes that the bankruptcy court "may, upon request of the Debtor or other party in interest in an appropriate case, apply some or all of" the guidelines to cramdowns and to partial prepackaged bankruptcies.ⁿ²⁷ However, the General Order does not offer any instruction as to what qualifies as an "appropriate case."

[b] Prefiling Notification.

The General Order also clarifies the process of prefiling notification. At least two business days prior to the anticipated filing date of the prepackaged chapter 11, the debtor should provide the United States trustee with notice of the proposed filing, copies of the plan and disclosure statement, and drafts of all "First Day Motions" and proposed orders, if possible, and should also provide a generalized informal notice of the proposed filing to the clerk of the court.ⁿ²⁸

[c] First Day Orders.

The General Order outlines the filing procedures for certain "First Day Orders." These orders either deal with administrative matters, or are used as a means of stabilizing the debtor's business pending bankruptcy. Requests for First Day Orders are to be made by motion, and are granted where the facts and circumstances so warrant.ⁿ²⁹

Part VI. C. of the General Order provides a (non-exhaustive) list of typical first day motions and orders to authorize, among other things, payment of prepetition wages, salaries and commissions; payments to employee benefit plans; payments to reimburse employees for ordinary business expenses; payments to creditors in the ordinary course of business when prepetition claims would be paid in full on consummation of the proposed plan; payments on prepetition customer claims, such as refunds of deposits, layaway plans and warranties; payments relating to the employment and compensation of appropriate professionals, such as attorneys, accountants and financial advisors; and payments which would allow the debtor to continue to perform under key executory contracts, including payment of prepetition amounts due.ⁿ³⁰

[d] Voting Procedures.

The General Order provides guidelines on conducting a valid voting process.ⁿ³¹ It states specific voting period durations that will ordinarily be considered reasonable by the court in specific circumstances, in accordance with the requirements of *Federal Rule of Bankruptcy Procedure 3018(b)*. Generally a court will approve as reasonable a period of twenty business days for securities that are listed on the New York or American Stock Exchanges or on any international exchange quoted on NASDAQ, or that are publicly traded on any other national exchange; a ten-business-day period for non-publicly traded securities; and a twenty-business-day period for all other claims and interests.ⁿ³²

The General Order does not explicitly state whether votes must be solicited from beneficial owners or the record holders of the debt or securities being restructured. It does note that "creditors and equity security holders who are not record holders of the securities upon which their claims or interests are based generally assume the risk associated with their

decision to hold their securities in 'street name.' "n33 The voting procedures, however, attempt to reach the beneficial holders as well.n34 Form ballots, though optional, are provided for both beneficial holders and record holders as Exhibits "B" and "C" to the General Order. While service of the confirmation hearing notice is made on the registered holders of debt and equity securities, the Court will review the adequacy of the debtor's proposed procedure of providing notice to the beneficial holders.n35

[e] Organizational Meetings and Creditors' Committee.

The General Order specifies when and under what circumstances the creditors' committee should be convened pursuant to *section 341(a) of the Bankruptcy Code*.n36

[f] Notice.

Finally, the General Order sets out guidelines regarding notice of the filing of the plan and disclosure statement and notice of the confirmation hearing and approval of the disclosure statement. More specifically, the General Order details the content and service of the hearing notice.n37

FOOTNOTES:

(n1)Footnote 1. *See P 9.08 infra*.

(n2)Footnote 2. *See P 9.09 infra*. For prepackaged plans filed in the Southern District of New York, General Order No. 201 (as incorporated by *Local Rule 3018-2*), *reprinted in* Collier Bankruptcy Practice Guide Local Rules Pamphlet--Second Circuit (Matthew Bender), provides guidance on many aspects of prefiling preparation. For a discussion of General Order 201, *see P 6.08[4] infra*.

(n3)Footnote 3. *11 U.S.C. § 1102(a)(1)*. In some instances, a creditors' committee may not be appointed in a prepackaged case if the plan provides for all trade and services creditors to be paid in full. *See In re Applied Extrusion Techs.*, Lex. No. 04-13388 (MFW) (Bankr. D. Del. 2004).

(n4)Footnote 4. Issues may arise as to whether a financial advisor or crisis manager that served as an interim officer of the troubled company prepetition is disqualified from being retained postpetition. *See Protocol for Engagement of Jay Alix & Associates and Affiliates*, available from the Office of the United States Trustee for Region 3.

(n5)Footnote 5. The debtor and any statutory creditors' committee may retain professionals compensated from the estate. *11 U.S.C. §§ 327 and 1103*. *See P 9.08[2] infra* for a discussion of the retention of professionals by a debtor. If the bankruptcy counsel used prior to filing the chapter 11 petition is not a disinterested party, the debtor will need to engage new counsel.

(n6)Footnote 6. *Fed. R. Bankr. P. 3017(a), (b)*.

(n7)Footnote 7. *11 U.S.C. § 1128(a); Fed. R. Bankr. P. 3020(b)(2)*.

(n8)Footnote 8. *See 11 U.S.C. § 365(d)(2)*.

(n9)Footnote 9. *See 11 U.S.C. § 362(d)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n10)Footnote 10. *See P 6.08[4][c] infra*.

(n11)Footnote 11. *See Fed. R. Bankr. P. 3003(c)(3)*.

(n12)Footnote 12. The elimination of a bar date adds to the company's flexibility with respect to timing, since twenty days' notice is required to fix a bar date. *Fed. R. Bankr. P. 2002(a)(8)*.

(n13)Footnote 13. These hearings may, but need not be, combined into a single hearing.

(n14)Footnote 14. *See P 6.07[2] supra*.

(n15)Footnote 15. For example, a bankruptcy court regards a liquidation analysis in support of the best interests test as material disclosure with respect to a plan of reorganization. *See P 6.05[2][b] supra*.

(n16)Footnote 16. *11 U.S.C. § 1129(a)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n17)Footnote 17. *11 U.S.C. § 1128(b)*.

(n18)Footnote 18. *See P 6.05[2][b] and [c] supra*.

(n19)Footnote 19. *11 U.S.C. § 1129(b)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n20)Footnote 20. *11 U.S.C. § 1129(a)(10)*.

(n21)Footnote 21. *11 U.S.C. § 1129(b)(1)*; *see P 6.05[2][a] supra*.

(n22)Footnote 22. *11 U.S.C. § 1129(b)(1)*.

(n23)Footnote 23. *See 11 U.S.C. § 1129(b)(2)(B)(ii)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n24)Footnote 24. *See P 6.08[4] infra*.

(n25)Footnote 25. In the Matter of the Adoption of Prepackaged Chapter 11 Case Guidelines, General Order 203, Amending General Order 201 (Bankr. S.D.N.Y. February 24, 1999) (the "General Order"), *reprinted in* Collier Bankruptcy Practice Guide Local Rules Pamphlet--Second Circuit (Matthew Bender). For a detailed discussion of the General Order, see S.E. Mayerson, *Current Developments in Prepackaged Bankruptcy Plans*, 838 PLI/Comm 337 (No. A0-00E6 April 2002).

(n26)Footnote 26. General Order, Part II. The contents of the "Prepack Scheduling Motion" are more fully explained in Part III. A. of the General Order. In addition, a suggested form for the Scheduling Motion is provided as "Exhibit A" to the General Order.

(n27)Footnote 27. General Order, Part III. D.

(n28)Footnote 28. General Order, Part IV. A-C.

(n29)Footnote 29. General Order, Part VI. A, B.

(n30)Footnote 30. General Order, Part VI. C; *see also* S. E. Mayerson, n.25 *supra*, at 351-52 (describing First Day Orders).

(n31)Footnote 31. General Order, Part VII.

(n32)Footnote 32. General Order, Part VII. A. However, a court is not precluded from finding that shorter or longer periods are reasonable in lieu of the recommended time periods. General Order, Part VII. B.

(n33)Footnote 33. General Order, Part VII. E.

(n34)Footnote 34. *See* S. E. Mayerson, n. 25 *supra*, at 350 .

(n35)Footnote 35. *See* S. E. Mayerson, n. 25 *supra*, at 350-351 . It bears repeating that the General Order is a set of guidelines, and provides no "safe harbors." While in many ways the General Order represents a laudable effort on the part of the bankruptcy court to strike a balance between concerns of efficiency and equity in the voting process, it does not change the solicitation requirements of § 1126(b) and *Fed. R. Bankr. P. 3018(b)*. *See* P 6.07[3] *supra*.

(n36)Footnote 36. General Order, Part VIII.

(n37)Footnote 37. General Order, Part X.



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CHAPTER 6 Prepackaged Bankruptcies

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P 6.09 Opposing a Prepackaged Plan.

[1] Overview.

A creditor may have a number of substantive reasons, other than realizing "holdout value," for opposing a restructuring plan, including inadequate treatment of its claim under the plan in light of the financial condition of the restructuring company and the treatment of other parts of the company's capital structure; disagreement with the company and other creditors over relative legal entitlements; loss of confidence in existing management; and concerns over feasibility of the plan. However, as discussed above, a restructuring effected through a prepackaged plan will, if accepted and confirmed, bind an opposing creditor.ⁿ¹

Presented with a "coercive" prepackaged bankruptcy, there are two broad lines of defense open to an opposing creditor. First, the creditor may challenge directly the treatment it receives under the plan and the company's ability to bind it. Second, the creditor may in a variety of ways challenge the proposed recoveries of other constituencies. In either case, the prospective ability to inject delay and uncertainty into the contemplated chapter 11 case may be a dissenting creditor's principal source of leverage in prepetition plan negotiations. However, both opposing creditors and constituencies supporting the plan need to evaluate the effects of possible challenges asserted in the chapter 11 case upon the process, the company and ultimate recoveries.

[2] Challenging Treatment Under the Plan.

[a] Improper Classification.

A dissenting holder can be bound by a plan that is accepted by the requisite percentage of other holders in the dissenter's class.ⁿ² However, each class must consist only of substantially similar claims,ⁿ³ and in general courts do not permit classes to be gerrymandered to dilute opposing votes or to create an accepting impaired class.ⁿ⁴ A dissenting holder that is classified with accepting holders of a different debt issue should investigate the possibility of a challenge to classification. While there are no specific rules, claims of different contractual priorities or with material differences in other contractual rights should not be classified together.

[b] Best Interests Test.

A dissenting holder cannot be bound by the class vote if the dissenting holder will receive less under the plan than it

would in a liquidation under chapter 7 of the Bankruptcy Code.ⁿ⁵ In many troubled situations, *de minimis* liquidation recoveries may be readily demonstrable for holders quite far up the capital structure, and it should be easy for plan proponents to show compliance with the best interests test in regard to these holders. However, where the issue is less clear, a dissenting holder may threaten to contest the valuation issue.ⁿ⁶

[c] Resisting a Cramdown.

A prepackaged plan that depends on a cramdown of an opposing class is likely to be rare. The contested nature of a cramdown is not compatible with a prepackaged bankruptcy, which is premised on predictability as to outcome and duration.ⁿ⁷ However, opposing creditors may have to evaluate and respond to the threat of cramdown in prepetition negotiations.ⁿ⁸

In a cramdown, secured lenders can be forced to accept a lengthened amortization schedule, but only to the extent that payments as deferred have a present value at least equal to the value of the secured creditors' collateral.ⁿ⁹ Accordingly, valuations of both the collateral and the future payment streams are unavoidable. Litigation of these issues, which are difficult to prove, is a significant deterrent to relying on a cramdown of secured debt.

A cramdown of unsecured debt carries a different sort of disincentive. An unsecured class that will receive less than the full amount of its claim can be crammed down only if no junior class receives or retains any property.ⁿ¹⁰ A restructuring company must sacrifice the entire interest of its equity holders (which may include management to a greater or lesser degree) to effect a cramdown of unsecured debt.

A cramdown may be opposed on the grounds that the plan discriminates unfairly against the dissenting class; that is, the dissenting class is treated less favorably under the plan than some other class or classes comprised of substantially similar claims.ⁿ¹¹ This argument, the converse of an allegation of gerrymandering the class vote,ⁿ¹² may be available, for example, where a different debt issue having no material differences in contractual rights is treated more favorably.

A cramdown of unsecured debt may also be challenged on the grounds that the dissenting class or junior classes extinguished to effect the cramdown are receiving less than they would in a liquidation under chapter 7 of the Bankruptcy Code.ⁿ¹³ If any class junior to the dissenting class is required to receive some distribution to comply with the best interests test with respect to that junior class, then the fair and equitable test cannot be met with respect to the dissenting class and it cannot be crammed down. If the best interests test were not met with respect to the dissenting class itself, it might not ultimately prevent a cramdown, but would require an adjustment of distributions under the plan.

[3] Challenging Other Constituencies.

[a] Appointing a Trustee or Examiner.

A creditor who has lost confidence in management may seek the appointment of a Chapter 11 trustee.ⁿ¹⁴ This remedy offers significant (although often belated) protection from fraud and mismanagement. Prospectively, a creditable threat to replace existing management must affect plan negotiations with the company, and the effect on operations must be carefully considered by other proponents of the "coercive" prepackaged bankruptcy. However, it should be borne in mind that the standard for appointment of a trustee is quite rigorous and will generally not be met except in egregious cases.ⁿ¹⁵

The appointment of an examiner is more readily obtained.ⁿ¹⁶ It is not uncommon for examiners to be appointed to investigate specific allegations of fraud or wrongdoing. The principal role of examiners appointed in chapter 11 cases involving failed LBOs has been to investigate possible fraudulent conveyance and preference actions against certain creditor constituencies. These matters go to the relative legal entitlements of the parties which underlie the negotiation and resolution of any restructuring plan. The prospect of such an investigation may induce parties to assess more

accurately an opposing creditor's avoidance claims and accord them appropriate weight in negotiations.

Alternatively, a dissenting holder that believes that it holds valid claims which, if litigated successfully, would improve its position vis-a-vis other creditors, might seek to challenge the priority accorded to more senior classes, thereby forcing a court to deal with these litigation issues. Since the plan could not be confirmed absent resolution of the appropriate priorities of the different creditor classes, the prepackaged bankruptcy could be delayed and even possibly derailed.

[b] Attacking Specific Interests.

Secured lenders often condition cooperation in a prepackaged plan on continued payment of interest during the pendency of the case. An opposing creditor can force the secured lenders to establish their statutory entitlement to such payments.ⁿ¹⁷ Similarly, elements of DIP financing arrangements that affect the relative positions of negotiating groups may be challenged.ⁿ¹⁸

Uninterrupted payment of prepetition trade debt has become a cornerstone of prepackaged bankruptcy.ⁿ¹⁹ Although precedent for these payments has accumulated, the statutory basis for permitting them is not entirely clear.ⁿ²⁰ Furthermore, courts that have approved these payments have undoubtedly been influenced by the fact that the payments are contemplated by a prepackaged plan already accepted by all impaired classes and all but confirmed. If an opposing creditor can call into question this assumption, management cannot be assured that the company's suppliers will not have a negative reaction to the filing of the chapter 11 case.

[c] Questioning Feasibility.

A creditor may oppose a plan as improvident. Even if all other requirements are met, a plan cannot be confirmed unless it is feasible. A bankruptcy court is required to find that the plan is not likely to be followed by the need for further financial restructuring.ⁿ²¹ One of the principal risks to impaired classes accepting a prepackaged plan is the unimpaired treatment of contingent, unliquidated and disputed claims. This treatment often may be necessary if a restructuring is to be effected in a prepackaged (as distinguished from a regular) bankruptcy.ⁿ²² However, a prepackaged bankruptcy may not be appropriate where there are significant contingent, unliquidated and disputed claims.ⁿ²³ An opposing creditor can challenge feasibility on the basis of such claims.ⁿ²⁴

FOOTNOTES:

(n1)Footnote 1. *See PP 6.01 and 6.02[1] supra* . Elimination of holdouts is one of the main reasons for pursuing a prepackaged plan. For a description of other advantages under the Bankruptcy Code available to a restructuring company in a prepackaged bankruptcy, *see P 6.04[3] supra*. For a summary of relevant tax considerations, *see P 8.07 infra*.

(n2)Footnote 2. *See P 6.02, n.2 supra* for a description of minimum acceptance requirements.

(n3)Footnote 3. *11 U.S.C. § 1122(a). See P 6.05[2][a] supra* for a discussion of classification requirements.

(n4)Footnote 4. *See, e.g., Barakat v. Life Ins. Co. of Va. (In re Barakat)*, 99 F.3d 1520, 1525-26, 37 C.B.C. 2d 356 (9th Cir. 1996) (noting that the principle that similar claims may not be classified separately for gerrymandering purposes has been adopted by "a majority of Circuits that have addressed the issue," and applying that principle); *Phoenix Mut. Life Ins. Co. v. Greystone III Joint Venture (In re Greystone III Joint Venture)*, 995 F.2d 1274, 1278, 26 C.B.C.2d 220, 224 (5th Cir. 1991) , *cert. denied*, 113 S. Ct. 72, 121 L. Ed. 2d 37 (1992) (invalidating a plan in which the debtor, to obtain approval of a class of impaired claims for cramdown purposes, had classified a \$3,500,000 unsecured deficiency claim separately from the \$10,000 in trade claims even though both would be treated alike under the plan); *but see Principal Mut. Life Ins. Co. v. Baldwin Park Towne Ctr. (In re Baldwin Park Towne Ctr.)*, 171 B.R. 374, 376 (Bankr. C.D. Cal. 1994) (disagreeing with the *Greystone* approach to classification, stating it places "an unfair

burden on the debtor to prove ... that it has a reason for the separate classification of the deficiency claim independent of its need to get an affirmative vote of an impaired class for confirmation ... [which] ... ignores the protections built into the Code by Congress under § 1129(b), which require that the plan not discriminate unfairly and be fair and equitable.").

(n5)Footnote 5. 11 U.S.C. § 1129(a)(7). See P 6.05[2][b] *supra* for a discussion of the "best interests" test.

(n6)Footnote 6. It is unusual for a class to accept a plan that offers a recovery inferior to one obtainable in a liquidation. One instance where this might happen is when accepting holders also have significant holdings in a second class that is favorably treated under the plan. Votes cast in one class to benefit the interests of another class might be susceptible to challenge as cast in bad faith. See P 6.03[2][b][iii] *infra* for a discussion of the good faith voting requirements of section 1126(e) of the Bankruptcy Code.

(n7)Footnote 7. See P 6.02 *supra*.

(n8)Footnote 8. See P 1.09[3][c] *supra* for a general description of the requirements for a cramdown of a dissenting class.

(n9)Footnote 9. 11 U.S.C. § 1129(b)(2)(A).

(n10)Footnote 10. 11 U.S.C. § 1129(b)(2)(B). This rule may be subject to the "new value" corollary or exception, discussed in P 1.09[3][c] *supra*.

(n11)Footnote 11. See 11 U.S.C. § 1129(b)(1); see P 6.05[2][a] *supra*.

(n12)Footnote 12. See P 6.09[2][a] *supra*.

(n13)Footnote 13. To be confirmed in a cramdown, a plan must comply with all requirements of section 1129(a) of the Bankruptcy Code other than the requirement that the plan be accepted by all impaired classes. 11 U.S.C. § 1129(b)(1). These requirements include meeting the so-called best interests test. See 11 U.S.C. § 1129(a)(7); P 6.05[2][b] *supra*.

(n14)Footnote 14. The United States trustee must move for the appointment of a chapter 11 trustee if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of debts or the debtor's public financial reporting. 11 U.S.C. § 1104(e).

(n15)Footnote 15. See 11 U.S.C. § 1104(a); Official Comm. of Unsecured Creditors of Cybergenics Corp. *ex rel. Cybergenics Corp. v. Chinery*, 330 F.3d 548, 560 (3d Cir. 2003) ("[w]hile ... the trustee serves a 'unique role' in Chapter 7, nothing could be further from the truth in Chapter 11, where trustees rarely exist.") (citation omitted); *In re Sharon Steel Corp.*, 871 F.2d 1217, 1225 (3d Cir. 1989) ("[i]t is settled that the appointment of a trustee should be the exception, rather than the rule"); *Schuster v. Dragone*, 266 B.R. 268, 271 (D. Conn. 2001) (explaining that the appointment of a trustee is an exception and an extraordinary remedy for creditors); 7 *Collier on Bankruptcy*, P 1104.02[1] (Matthew Bender 15th Ed. Revised) (observing that appointment of a trustee is permitted in "extraordinary cases," such as when "the debtor or its managers have engaged in serious fraud or dishonesty, or have grossly mismanaged the business[, or] when there are irretrievable conflicts or [] creditors have completely lost confidence in" the debtor's management).

(n16)Footnote 16. See 11 U.S.C. § 1104(c), which allows a court, at any time before confirmation, upon motion and after notice and a hearing, to order appointment of an examiner 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."

(n17)Footnote 17. A secured creditor is entitled to postpetition interest on its claim only to the extent that the value of the underlying collateral exceeds the amount of the claim. *11 U.S.C. § 506(b)*. Whether or not a lender has a valid, perfected and unavoidable lien on a property of the restructuring company and the value of any such collateral may be litigable issues.

(n18)Footnote 18. *See P 6.06[2][b][ii] supra*.

(n19)Footnote 19. *See P 6.04[2][a][ii] supra*.

(n20)Footnote 20. *See P 6.04[2][a][ii][B] supra*.

(n21)Footnote 21. *11 U.S.C. § 1129(a)(11)*.

(n22)Footnote 22. *See P 6.05[4] supra*.

(n23)Footnote 23. *See P 6.04[1][b] supra*.

(n24)Footnote 24. In determining feasibility, a bankruptcy court will take into account, among other things, contingent, unliquidated and disputed claims. *See P 6.05[4], n.19 supra* and accompanying text.



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Collier Business Workout Guide

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CHAPTER 6 Prepackaged Bankruptcies

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P 6.10 FORM 6-1: Form of Confidentiality Agreement.

**PRIVATE AND
CONFIDENTIAL**

[*Date*]

[*Name and Address of Institution*]

Attention: [*Name of Contact*]

Ladies and Gentlemen:

In connection with a possible restructuring (the "Restructuring") of certain liabilities of _____ [***Name of Company***] (the "Company"), you have agreed to execute this agreement (this "Agreement").ⁿ¹ In connection therewith, you have requested certain information concerning the Companyⁿ² from its directors, officers, employees, representatives and/or agents, including without limitation, attorneys, accountants, consultants, bankers and other financial advisors (the "Company Representatives"). All such information furnished to you or your directors, members, officers, employees, agents or advisors including without limitation, attorneys, accountants, consultants, bankers, potential debt and equity financing sources and other financial advisors (collectively, your "Representatives") by or on behalf of the Company, irrespective of the form of communication, including, without limitation, any oral or written information, discussions, negotiations, term sheets, presentations or proposals related to the Restructuring, furnished to you or your Representatives by or on behalf of the Company and whether such information was furnished prior to the date hereof or is furnished now or will be furnished in the future, [and any analyses, compilations, forecasts, and/or other documents prepared by you or your Representatives containing or based in whole or in part upon any such furnished information]ⁿ³ is collectively referred to herein as the "Information."

Notwithstanding anything to the contrary herein, the Information does not include any information which (i) is or becomes publicly available other than as a result of a disclosure by you or any of your Representatives, (ii) is already in your or any of your Representatives' possession and was not furnished by the Company or the Company Representatives, *provided that* such information is not known by you or any of your Representatives, to be subject to any legal or contractual obligation of confidentiality or secrecy owed to the Company or other party, (iii) is or becomes

available to you or any of your Representatives on a non-confidential basis from a source other than the Company or the Company Representatives, *provided that* such source is not known by you or any of your Representatives, to be bound by any confidentiality agreement with, or other obligation of secrecy to, the Company or another party [, or (iv) is independently developed by you or on your behalf without violating any of your obligations hereunder.]n4

In consideration of furnishing you with the Information, you have agreed to the following:

1. The Information will be used solely for the purpose of evaluating the Restructuring and alternatives. The Information will be kept strictly confidential in accordance with the terms hereof by you and your Representatives and will not be disclosed by you or your Representatives except:

(a) to acquire or agree, offer, seek or propose to acquire ownership (or request permission to do so), including without limitation beneficial ownership as defined in Rule 13d-3 under the Exchange Act, of any of the Company's assets, businesses, claims or stock or other securities or any rights or options to acquire such ownership;

(b) to those of your Representatives who need to know such information for the purpose of evaluating the Restructuring and alternatives, each of whom shall be advised by you of the confidential nature of the Information and the terms of this Agreement and instructed by you to treat such Information in accordance with the terms of this Agreement;

(c) as required by law, regulation or legal or judicial process, provided that, where such disclosure is required,

(i) you shall provide the Company with prompt notice of such request or requirement so that the Company has an opportunity as far in advance of disclosure as is practicable to review the disclosure before the disclosure is made, and to seek a protective order or waive compliance with the provisions of this Agreement; and

(ii) in the event that no protective order has been obtained and you or any of your Representatives is nonetheless compelled in a proceeding to disclose any Information, you or your Representatives may disclose such Information without liability under this Agreement, *provided, however*, that (x) you and your Representatives may disclose only that portion of the Information which you are advised by counsel is legally required to be disclosed; (y) you give the Company written notice of the Information to be disclosed as far in advance of its disclosure as is practicable so that the Company may seek to obtain assurances that it will be accorded confidential treatment; and (z) you use your best efforts to cooperate with the Company in seeking to obtain any protective order or other assurance of confidential treatment of Confidential Material contemplated hereby.

(d) as otherwise provided in this Agreement.

You will be responsible for any breach of this Agreement by you or any of your Representatives.

2. Except with regard to your Representatives in accordance with Section 1(b) of this Agreement, you agree that, without the prior written consent of the Company, neither you nor your Representatives will disclose to any other person, including the media and any corporation, company, group, partnership, or other entity or individual, either:

(i) that you or any of your Representatives have received Information from the Company or the Company's Representatives or that Information has been made available by the Company; or

(ii) the fact that any investigations, discussions, or negotiations are taking place concerning a possible Restructuring, including any of the terms, conditions or other facts with respect to any such possible Restructuring, and the status thereof, except that each party may make such disclosure if upon [written] advice of counsel, such disclosure must be made in order to comply with applicable law, regulation or legal or judicial process, subject to full compliance with Section 1(c) hereof.n5

3. You hereby acknowledge that you are aware, and that you will advise your Representatives,ⁿ⁶ that the Information may contain material non-public information and that the United States securities laws restrict any person who has received from an issuer any material, non-public information from purchasing or selling securities of such issuer, or from communicating such confidential information to any other person under circumstances in which it is reasonably foreseeable that such person is likely to purchase or sell securities.ⁿ⁷

4. For a period of [*insert duration of standstill*]ⁿ⁸ from the date of this Agreement, without the prior written request of the Company, neither you nor any of your Representatives or your affiliates (as defined in Rule 12b-2 under the Securities Exchange Act, as amended (the "Exchange Act")) will [or will assist or advise others to] directly or indirectly:

(a) acquire or agree, offer, seek or propose to acquire (or request permission to do so) ownership (including without limitation beneficial ownership as defined in Rule 13d-3 under the Exchange Act) of any of the Company's assets, businesses, claims or stock or other securities or any rights or options to acquire such ownership;

(b) seek, or propose, to influence or control the Company's management or policies (or request permission to do so); or

(c) enter into arrangements or understandings with any third party with respect to any of the foregoing.

If at any time during such period you are approached by any third party concerning your or their participation in a transaction involving the Company's assets or businesses or securities or any effort to control the Company's management policies, you will promptly inform the Company of the nature of such contact and the parties thereto.ⁿ⁹

5. Each party hereto agrees that money damages would not be a sufficient remedy for any breach of this agreement by you or your Representatives and that the Company shall be entitled to equitable relief, including injunction and specific performance, in the event of any such breach, in addition to all other remedies available to the Company at law or in equity. Nothing contained herein shall limit your rights to contest the confidential status or materiality of any Information.

6. The parties hereby agree that this agreement shall be governed by and construed in accordance with the laws of [*insert governing law*] without giving effect to its conflict of laws principles or rules. The parties hereby irrevocably consent to the non-exclusive jurisdiction of the state and federal courts located in [*insert jurisdiction*] for any actions, suits or proceedings arising out of or relating to this agreement.

7. If any provision of this agreement is found to violate any statute, regulation, rule, order or decree of any governmental authority, court, agency or exchange, such invalidity shall not be deemed to affect any other provision hereof or the validity of the remainder of this Agreement, and such invalid provision shall be deemed deleted herefrom to the minimum extent necessary to cure such violation.

8. This Agreement shall constitute the entire agreement between the parties with regard to the subject matter thereof. No modification, amendment or waiver shall be binding without the written consent of the parties hereto. This agreement shall inure to the benefit of and be binding upon the parties and their respective successors and assigns.

9. The confidentiality provisions of this Agreement shall terminate on the earliest of:

(i) [*Insert length of time or specific date*] [after the date hereof];

(ii) the date of announcement of the main terms of a Restructuring in a Form 8-K or a press release; or

(iii) the mailing of a disclosure statement and plan of reorganization pursuant to *Section 1126 of the United States*

Bankruptcy Code or the filing of a disclosure statement and a plan of reorganization for the Company with the United States Bankruptcy Court.ⁿ¹⁰

10. Upon written request of the Company, you will, and you will cause your Representatives to, promptly redeliver to the Company all copies of tangible Information, and promptly destroy all memoranda, notes and other material prepared by you or any of your Representatives based on the Information, with such destruction certified to the Company by one of your officers. No Information shall be retained by you or your Representatives in any form or for any reason.

11. Although the Company will endeavor to include in the Information material which it believes to be relevant for the purpose of your investigation, you acknowledge that neither the Company nor any Company Representative makes any representation or warranty as to the accuracy or completeness of the Information. You agree that neither the Company nor the Company Representatives shall have any liability to you or any of your Representatives resulting from any use of the Information.ⁿ¹¹

If you agree with the foregoing, please sign and return a copy of this Agreement, which will constitute our agreement with respect to the subject matter of this Agreement.

Very truly yours,

[Name of Company]

By _____

Name: _____

Title: _____

Acknowledged and agreed to as
of the date of this letter:

[Name of Financial Advisor]

By _____

Name: _____

Title: _____

Dated: _____

FOOTNOTES:

(n1)Footnote 1. A confidentiality agreement may be entered into during the stage in which a financial advisor is contemplating an engagement. In such case, language regarding the advisor's evaluation of the potential engagement and restructuring would be included.

(n2)Footnote 2. Include reference to affiliates if applicable.

(n3)Footnote 3. Financial advisors may object to having their work product subject to confidentiality restrictions, while Companies insist that work product derived from non-public information remain protected. Subsection (iv) in the following paragraph can serve as a compromise.

(n4)Footnote 4. *See* n.3 *supra*.

(n5)Footnote 5. If the Confidentiality Agreement is entered into prior to the engagement of the financial advisor, the following may be added: "(iii) the fact that any investigations, discussions, or negotiations are taking place concerning a possible engagement."

(n6)Footnote 6. Agreements with financial advisors to bondholders or banks should include the language "and your clients."

(n7)Footnote 7. If the Confidentiality Agreement is entered into by large investors who may balk at this paragraph, the following language may be requested by such investor:

However, nothing contained in this Agreement shall prevent you from purchasing or selling securities issued by the Company, through privately negotiated transactions in compliance with applicable securities laws, from or to a person or entity that is an accredited investor (within the meaning of section (2)15 of Regulation D of the Securities Act of 1933, as amended) who has acknowledged in writing to you that you may hold material, non-public information of the Company which will not be disclosed to such person or entity.

(n8)Footnote 8. A standstill provision of this sort can be controversial. A company may desire to modify or omit this provision.

(n9)Footnote 9. Financial Advisors may request the following:

Notwithstanding anything to the contrary provided elsewhere herein, none of the provisions of this Agreement shall in any way limit the personnel of your affiliates (*provided that* such personnel are not involved in your restructuring advisory business), from trading in, making a market in, advising on, or otherwise being involved in the purchase or sale of securities of the Company *provided that* the Information is not shared with such affiliates and that appropriate firewall measures as may be sufficient under United States securities laws (including, without limitation, of the type described in Rule 10b5-1(c)(2) of the Securities Exchange Act of 1934) are taken to ensure confidentiality.

(n10)Footnote 10. In the case of an out-of-court restructuring or exchange offer, this clause should be changed to: "the date that the Information received by you in connection with the Restructuring is disclosed in a filing the Company submits to any regulatory authority pursuant to any applicable securities law or regulation."

(n11)Footnote 11. The following paragraph should be added to a Confidentiality Agreement regarding a potential engagement of a financial advisor:

"If you determine not to proceed with the Engagement within a reasonable time, you shall promptly inform the Company of that decision and redeliver to the Company all Information (whether prepared by the Company, the Company's Representatives or otherwise) and will not retain any copies, extracts or other reproductions in whole or in part of such Information. All documents, memoranda, notes and other writing whatsoever prepared by you or your Representatives based on the Information shall be destroyed, and such destruction shall be certified in writing to the Company by one of your officers. You shall remain bound by the terms of this agreement with respect to any Information delivered to you or your Representatives prior to receipt by the Company of a written notice of termination."



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CHAPTER 6 Prepackaged Bankruptcies

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P 6.11 FORM 6-2: Form of Lock-Up Agreement.

This LOCK-UP AGREEMENT (this "Agreement") dated as of _____ [date] by and among the undersigned holders (each, an "Executing Holder," and collectively, the "Executing Holders") of the [insert title of security] (the "Notes") of [insert name of issuer] (the "Company").

RECITALS

WHEREAS, the Company is currently contemplating a restructuring (the "Restructuring") upon the terms and conditions set forth in the term sheet dated _____, attached hereto as Exhibit A (the "Term Sheet");n1 which Term Sheet has been negotiated with and agreed upon by the Executing Holders; and

[WHEREAS, the Company intends to commence a voluntary case (the "Chapter 11 Case") under chapter 11 of title 11 of the United States Code (the "Bankruptcy Code") and contemporaneously file its disclosure statement (the "Disclosure Statement") and propose a plan of reorganization in the Chapter 11 Case (the "Plan") both in all material respects consistent with the Term Sheet];n2 and

WHEREAS, the Executing Holders are prepared to commit, on the terms and subject to the conditions of this Agreement, to support the Plan.

NOW, THEREFORE, in consideration of the premises and the mutual covenants and agreements set forth herein, and for other good and valuable consideration, the receipt and sufficiency of which are hereby acknowledged, the parties hereby agree as follows:

1. Support of Plan.

(a) Subject to Section 1(b) hereof, each Executing Holder shall, when solicited after receipt of the applicable disclosure documents,

(i) timely vote 100% of the outstanding principal amount of its Notes to accept the Plan and not revoke or withdraw such vote except as permitted hereunder;

(ii) not object to confirmation of a Plan that satisfies the Conditions (as defined below) or support any such objections by a third party or otherwise commence any proceeding to oppose or alter the Plan;

(iii) not vote for, consent to, support, or participate in the formulation of any other plan of reorganization or liquidation proposed or filed or to be proposed or filed in any chapter 11 or chapter 7 case commenced in respect of the Company provided that the Company files and is supporting the Plan;

(iv) not directly or indirectly seek, solicit or support (or encourage any person or entity to seek, solicit or support) any other plan, proposal or offer of dissolution, winding up, liquidation, reorganization, merger or restructuring of the Company that could reasonably be expected to prevent, delay or impede the successful restructuring of the Company as contemplated by the Plan;

(v) not object to the Plan or the solicitation of consents to a Plan that satisfies the Conditions or support any such objection by a third party; and

(vi) not take any other action that is inconsistent with or that would delay confirmation of a Plan that satisfies the Condition.ⁿ³

(b) The obligations of the Executing Holders set forth in Section 1(a) are subject to the following conditions (the "Conditions"), any of which may be waived in writing by the Applicable Representative:ⁿ⁴ that (i) the terms of the Plan include and/or are consistent in all material respects with the terms of the Term Sheet, and (ii) the terms of all documents related to the Plan to be provided to the representatives of each party hereto include and/or are consistent in all material respects with the terms of the Term Sheet.ⁿ⁵

(c) Nothing contained herein shall limit the ability of the Executing Holder to consult with the Company, or to appear and be heard, concerning any matter arising in the Chapter 11 Case so long as such consultation or appearance is not inconsistent with the Executing Holder's obligations hereunder and the terms of the Plan.

2. *Reorganization Plan.* The Company shall:

(a) use commercially reasonable efforts to cause the solicitation pursuant to the Disclosure Statement and Plan to commence on or before [_____, 200____];

(b) file with the Bankruptcy Court the Plan and Disclosure Statement on or before [_____, 200____];

(c) obtain Bankruptcy Court approval on an interim basis and final basis for the use of its secured lenders' cash collateral promptly after the filing of the Chapter 11 Case on terms and conditions and subject to a cash collateral stipulation and order in form and substance acceptable to the Executing Holders; and

(d) consummate the Plan on or before [_____, 200____].ⁿ⁶

3. *Ownership of Notes.* Each Executing Holder represents that (a) it is the beneficial and/or record owner of the principal amount of Notes set forth beneath its signature at the end of this Agreement, which amount represents 100% of such Executing Holder's record and/or beneficial ownership of the Notes as of the date hereof, (b) to the best of its knowledge, no affiliate of such Executing Holder owns beneficially or of record, or has any other economic interest in, any Notes, and (c) as to Notes held by it solely as record holder, it has been duly authorized by the beneficial owner thereof to execute, deliver and perform this Agreement.ⁿ⁷

4. *Acknowledgment* This Agreement is not and shall not be deemed to be a solicitation for consents to the Plan.

5. *Termination of Agreement and Consenting Holders' Obligations.* Each Executing Holder may terminate its obligations hereunder and this Agreement shall terminate if any of the following events (any such event, a "Termination Event") occurs: (i) the Company withdraws from consideration by the Bankruptcy Court (and does not promptly refile) any Plan that satisfies the Conditions, (ii) the Company files, propounds or otherwise supports any Plan or other plan of reorganization or liquidation that does not satisfy the Conditions, (iii) the Company shall have materially breached any of its obligations or failed to satisfy in any material respect any of the terms or conditions under this Agreement, including without limitation, the provisions of Section 2 hereof, or (iv) an examiner with expanded powers or a trustee shall have been appointed in the Chapter 11 Case, the Chapter 11 Case shall have been converted to a case under Chapter 7 of the Bankruptcy Code, or the Chapter 11 Case shall have been dismissed by order of the Bankruptcy Court.ⁿ⁸

6. *Restrictions on Transfer.* Each Executing Holder hereby agrees that, during the period commencing on the date hereof and ending on the earlier of (i) _____ business days after expiration of the solicitation of acceptances of the Plan; (ii) **[insert date]**; or (iii) the date that a Termination Event first occurs, it shall not sell, transfer or assign any claims arising under or evidenced by the Notes and related documents or any option thereon or any right or interest therein (the "Relevant Claims"), unless the transferee thereof agrees in writing to be bound by all the terms of this Agreement by executing a counterpart signature page of this Agreement and the transferor provides the Company with a copy thereof. Notwithstanding anything to the contrary herein or in any of the underlying documents related to the Notes, any such purported transfer in violation of this Section 6 shall be void and of no force and effect.

7. *Further Acquisition of Notes.* This Agreement shall in no way be construed to preclude any Executing Holder from acquiring additional Notes of the Company. However, any such additional Notes so acquired shall automatically be deemed to be subject to the terms of this Agreement.ⁿ⁹

8. *Access to Information.* By its execution of this Agreement, each Executing Holder acknowledges that it has been afforded the opportunity to discuss the Term Sheet and other information concerning the Company with representatives of the Company, and to consult with its legal counsel and financial advisors with respect to its investment decision to execute this Agreement. Each Executing Holder further acknowledges that it has otherwise investigated this matter to its full satisfaction and will not seek rescission or revocation of this Agreement.

9. *Impact of Appointment to Committee.* Notwithstanding anything herein to the contrary, in the event that any party hereto is appointed to and serves on a supervisory committee in the bankruptcy proceeding, including, without limitation, any creditors' committee formed under *section 1102 of the Bankruptcy Code* or any other committee formed under the Bankruptcy Code, the terms of this Agreement shall not be construed so as to limit such party's exercise of its fiduciary duties to any person arising from its service on such committee, and any such exercise of such fiduciary duties shall not be deemed to constitute a breach of the terms of this Agreement (but the fact of such service on such committee shall not otherwise affect the continuing validity or enforceability of this Agreement).ⁿ¹⁰

10. *Termination Date.* This Agreement shall terminate and be of no further force and effect at the close of business at 5:00 p.m., **[insert time zone]** time on **[insert date]**.

11. *Specific Performance.* It is understood and agreed by each of the parties hereto that money damages would not be a sufficient remedy for any breach of this Agreement by any party and each non-breaching party shall be entitled to specific performance and injunctive or other equitable relief as a remedy of any such breach.

12. *Consideration.* It is hereby acknowledged by the parties hereto that no consideration shall be due or paid to any of the Executing Holders for their agreement to support the Plan in accordance with the terms and conditions of this Agreement other than the Company's agreement to use its reasonable best efforts to obtain approval of the Disclosure Statement and to take all steps necessary and desirable to confirm the Plan in accordance with the terms and conditions

of this Agreement.

13. *Successors and Assigns.* This Agreement shall be binding on and inure to the benefit of the parties and their respective successors, assigns, heirs, executors, administrators and representatives, subject to Section 6 hereof.

14. *Severability.* If any provision of this Agreement is held to be invalid or unenforceable in whole or in part, such invalidity or unenforceability shall attach only to such provision or part thereof and the remaining part of such provision hereof shall continue in full force and effect.

15. *Counterparts.* This Agreement may be executed in one or more counterparts, each of which shall be deemed an original and all of which shall constitute one and the same Agreement.

16. *Headings.* The headings of the sections, paragraphs and subsections of this Agreement are inserted for convenience only and shall not affect the interpretation hereof.

17. *Amendments.* This Agreement may not be modified, amended or supplemented except in a writing signed by each of the signatories hereto.

18. *Governing Law.* This Agreement shall be governed by and construed in accordance with the laws of the State of _____ **[insert state]**, without giving effect to any applicable conflict of laws principles.

IN WITNESS WHEREOF, each of the parties hereto has caused this Agreement to be executed and delivered by its duly authorized officer as of the date first above written.

[Name of Holder]

By _____

Name: _____

Title: _____

[Title of Security] \$_____ **[insert principal amount of security]**

FOOTNOTES:

(n1)Footnote 1. Alternatively, reference may be made to the disclosure statement or offering documents if it has been prepared and disseminated.

(n2)Footnote 2. In the case of an out-of-court restructuring, this clause should be replaced by a description of the exchange offer or other transaction.

(n3)Footnote 3. In the case of an exchange offer and/or consent solicitation, these terms will also include any specific voting requirements with respect to the exchange offer and/or consent solicitation.

(n4)Footnote 4. "Applicable Representative" shall mean, a representative directed by holders [of at least 75%] of the aggregate dollar amount of such Executing Holders' claims.

(n5)Footnote 5. In the case of an exchange offer and/or consent solicitation, the conditions may also include the distribution of offering materials and other securities laws compliance terms.

(n6)Footnote 6. In the case of an exchange offer and/or consent solicitation, these requirements will relate to the opening and closing of the offering and consent solicitation and the drop-dead date on the out-of-court restructuring once the offering and consent solicitation are successful.

(n7)Footnote 7. In the case of an exchange offer and/or consent solicitation, the Executing Holders may request that their individual holdings are not disclosed to the Company, but only on file with the Executing Holder's counsel or the bondholder committee counsel (who would then provide the Company with an aggregate amount of debt covered by the lock-up agreements). This should be resisted by the Company, as it may provide holders of small positions with significantly more leverage in the negotiation process.

(n8)Footnote 8. In the case of an exchange offer and/or consent solicitation, paragraphs 4 and 5 would be adjusted to (1) acknowledge that such agreement is not a solicitation for consents to the consent solicitation and (2) include negotiated termination conditions.

(n9)Footnote 9. The following additional provisions are optional:

Releases. Each of the Executing Holders agrees (i) that on the effective date of the Plan, it will deliver a release in form and substance satisfactory to the Company releasing the Company's current and former officers, directors, employees, consultants, financial advisors, attorneys, accountants and other representatives who served in such capacity during the bankruptcy proceeding or the negotiation and formulation of the Term Sheet or Plan, (collectively, the "Releasees"), from any and all claims (as defined in *Section 101(5) of the Bankruptcy Code*), obligations, suits, judgments, damages, rights, causes of action, and liabilities whatsoever, whether known or unknown, foreseen or unforeseen, existing or hereafter arising, in law, equity or otherwise, that any Executing Holder is entitled to assert against any of the Releasees, based in whole or in part upon any act or omission, transaction, agreement, event or occurrence taking place on or before the effective date of any reorganization, in any way relating to the Company or its subsidiaries, the bankruptcy proceeding or the negotiation, formulation and preparation of the Term Sheet or Plan or any related documents, subject to delivery of a similar release in favor of the Executing Holders and their respective current and former officers, directors, employees, consultants, financial advisors, attorneys, accountants and other representatives who served in such capacity during the bankruptcy proceeding or the negotiation and formulation of the Plan, and (ii) not to object to any such release or exculpation provisions consistent with the terms hereof.

Waiver of Claims. The Company does not possess and will not assert, any claim, counterclaim, setoff or defense of any kind or nature, which would in any way affect the validity or enforceability of any claim arising from the Notes, or which would in any way reduce or affect the absolute and unconditional obligation of the Company to pay all of the obligations arising from the Notes.

Disclosure. Unless required by applicable law or regulation or a ruling by a court of competent jurisdiction, the Company shall not disclose the identity of any Executing Holder or any Executing Holder's holdings of Notes without the prior written consent of such Executing Holder, and if such announcement or disclosure is so required by law or regulation or court ruling, the Company shall afford such Executing Holder a reasonable opportunity to review and comment upon any such announcement or disclosure prior to such announcement or disclosure. The foregoing shall not prohibit the Company from disclosing the approximate aggregate holdings of Notes by the Executing Holders as a group, from disclosing the terms of this Agreement and identity of the Executive Holders to the U.S. Trustee for purposes of selecting a creditors' committee, or from disclosing the existence and terms of this Agreement and that the Executing Holders have expressed support for the Plan (without identifying any individual Executing Holder).

(n10)Footnote 10. Paragraphs 8 and 9 are not required in the case of an exchange offer and/or consent solicitation.



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CHAPTER 7 Investing in a Troubled Company

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CHAPTER 7 Investing in a Troubled Company

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P 7.01 Scope of This Chapter.

The multi-billion trading market for claims against, and stock of, distressed companies is well established.

The debt and equity securities of troubled companies are often undervalued by the market. Nevertheless, some of these companies will successfully reorganize and their securities will rebound. If a restructuring can cure the company's insolvency and increase its value, the company's insolvency-depressed securities may be temporarily undervalued.

However, not every restructuring succeeds, not every class of securities benefits from a successful restructuring and, sometimes, a "successful" restructuring may not benefit any security holders. Moreover, an investor who correctly predicts the success of a restructuring and buys the "right" securities may still lose money by buying too early. The profitability of an investment in the debt or equity of a troubled company depends on the investor's successful bet that the company's post-reorganization value will yield the creditors or stockholders more than the price that the investor paid for its claim or stock, and that the reorganization will be achieved before the investor's costs of carrying the investment--the time value of money and the expenses incurred, and time spent, by the investor in the restructuring process--consume whatever profit the investor hopes to make from the discount.

In each case, the investor must consider at a minimum: (i) what kind of restructuring is being sought by the company; (ii) what kind of restructuring would be the most beneficial for the particular investment; (iii) how likely the restructuring is to succeed; and (iv) how long it will take for the restructuring to succeed. Understanding the restructuring process and the opportunities and risks involved may help the investor make an informed investment decision.

In addition, to reduce their debt or improve their liquidity, troubled companies often consider selling valuable assets or even entire businesses, which creates acquisition opportunities for both financial and strategic purchasers. For the most part, acquisitions of assets of troubled companies are not very different from acquisitions of assets of healthy ones. However, it is important for the potential purchaser to understand the particular risks involved in dealing with a troubled company, as well as the advantages and disadvantages of asset sales both in and out of chapter 11.

This chapter will focus on certain concerns that should be addressed before buying debt, equity or assets of a troubled company. We will first present an overview of the reasons why one would invest in or acquire assets of troubled companies. The chapter will then describe certain ways of investing in a troubled company and discuss the factors that

may make these investments more risky than others, including the problems associated with an out-of-court restructuring. Since there is no guarantee that an out-of-court restructuring will be successful must be aware of both the problems and opportunities that present themselves in chapter 11, the discussion will also include an overview of certain risks for, and opportunities available to, investors if the company slips into bankruptcy, including strategies involved in making further investments in the company once it is in chapter 11. Finally, we will discuss acquisitions of assets of troubled companies, focusing on asset sales pursuant to *section 363 of the Bankruptcy Code*. After describing certain risks involved for prospective purchasers and break-up fees and other bid protections available to them in that context, we will highlight certain due diligence considerations for purchasers dealing with a chapter 11 seller.



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P 7.02 Why Invest in a Troubled Company?

[1] Investing for a Higher Return.

A troubled company's securities, priced at depressed levels, present opportunities for investors willing to gamble on the company's ability to work its way out of its troubles. Ordinarily, one would presume that the market's projection (as reflected in the securities' low prices) that the company will not succeed in its rebuilding effort will most likely be correct. Thus, a risk-taker, in making an investment, would merely be betting on its own projections on the company's prospects being more accurate than those of the market.

However, there may also be factors (other than purely economic ones) resulting from the troubled company's situation, which may lead to the company's securities being undervalued by the market. In particular, a company facing an out-of-court workout of its debt presents complications for many investors. Workouts are lengthy and expensive for the company and creditors alike. Certain investors may be unwilling or unable to wait out the process and thus may be anxious to sell their holdings.

Workouts present other opportunities to investors. Since a debt restructuring often requires the approval of a specified percentage of debt holders, a holder of at least that specified amount of debt might be able to hold up approval until it obtains favorable consideration. Thus, if a workout seems imminent, an investor may wish to invest in a sufficient amount of debt securities to effect a holdout.

Finally, an investor who loans money to a troubled company in order to fund a workout also benefits. In addition to receiving a higher rate of return in order to compensate it for its risks, an investor who also holds other debt in the company purchased at a discount may be able to capitalize on the spread between the amount that it is willing to fund (and thus receive on account of such other debt holdings) and the lower price of the debt that it purchased.

[2] Obtaining Control of the Troubled Company.

In addition to trying to obtain control of a troubled company through the customary channels of an acquisition of voting stock, an investor may be able to obtain control of the company by an acquiring a large position in the company's debt. Outside of bankruptcy, the investor may seek to gain control by obtaining a blocking position in the workout or funding the workout. As a consequence of its holdout position or funding, it may be able to obtain enough leverage to obtain equity securities, and perhaps control, in return for its investment in the workout. In order to succeed, the investor must

be in a position to force the company to bargain with it -- the greater the investor's importance to the company, of course, the greater its leverage.

[3] Purchasing Assets at a Discount and Free of Liens.

Under pressure to pay down debt or to avoid a liquidity crisis, troubled companies can be highly-motivated sellers. The particular constraints under which troubled companies operate often create opportunities to purchase assets at a discount and give more bargaining power to potential purchasers than in a non-distressed context.

If the acquisition occurs once the seller is in chapter 11, *section 363 of the Bankruptcy Code* allows the assets to be sold to the purchaser, pursuant to an order of the bankruptcy court, free and clear of most claims and encumbrances. Thus, in certain circumstances, the purchaser may enjoy greater protection against liabilities that have not been assumed by contract.ⁿ¹ Section 363 sales can be used to acquire the entire business, or only certain assets of, a debtor.

FOOTNOTES:

(n1)Footnote 1. *See P 7.05 infra.*



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CHAPTER 7 Investing in a Troubled Company

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P 7.03 Ways of Investing in a Troubled Company.

[1] Overview.

One of the fundamental concerns of an investor in a troubled company is that the company will slide into bankruptcy. However, bankruptcy may not be disastrous to every investor; in fact, some might use the threat of putting the company into involuntary bankruptcy as a way of increasing their leverage in workout negotiations.ⁿ¹ An investor might prefer the orderly process of the bankruptcy reorganization, especially if it is willing to loan further moneys to the company based on super-priority status under *section 364 of the Bankruptcy Code*.

Finally, bankruptcy may assist the investor hoping to use its investment to take over the troubled company. Acquiring a troubled company is not simply a game of purchasing sufficient shares of equity to gain control over management as the right of the shareholders of an insolvent company to call a shareholders' meeting to elect directors may be limited. In fact, shareholders may even lose their equity interests altogether in bankruptcy. Instead, a potential acquiror will often be more successful in obtaining control of the company by gaining control over the reorganization process itself, by purchasing large positions in the claims of the company and forcing the company to adopt a plan that includes the acquisition by the investor. Alternatively, a potential acquiror may obtain control of the company by funding a plan or providing debtor-in-possession financing that is convertible into equity of the reorganized company.

This section reviews the ability of investors in a chapter 11 debtor to obtain control of the company by purchasing a controlling equity stake in the company or blocking positions in its debt, and by funding a plan or providing debtor-in-possession financing to the company.ⁿ²

[2] Purchasing Securities.

[a] Purchasing Equity.

An investor in equity securities may be able to control the company through a shareholders' vote. The shareholders' right to elect the company's directors under state law remains in full force during the pendency of a workout.ⁿ³

The general rule that the shareholders have a right to call a shareholders' meeting and elect directors will be recognized even in bankruptcy, absent "clear abuse."ⁿ⁴ In *In re Johns-Manville Corp.*,ⁿ⁵ a bankruptcy court enjoined a special meeting called by the debtor's Equity Committee to replace directors on the ground that the holding of the meeting

would obstruct Manville's reorganization. The appellate court reversed the bankruptcy court's decision, saying that Manville had not demonstrated that it would sustain irreparable harm if the meeting was held. The court held that in order to find clear abuse, the bankruptcy court was required to "analyze the real risks to rehabilitation posed by permitting the Equity Committee to call a meeting of shareholders for the purpose of compelling reconsideration of Manville's presently proposed plan."ⁿ⁶ Upon remand, the bankruptcy court enjoined the calling of the shareholders' meeting using the "clear abuse" standard.ⁿ⁷

In *In re Allegheny International, Inc.* ⁿ⁸ the district court, on *de novo* review, considered a bankruptcy court's enjoining of a shareholders' meeting called to replace management. The bankruptcy court had reasoned that a proxy fight over management was inconsistent with the debtor's exclusivity period. The district court disagreed, stating that the possibility of a delay in the submission of a plan and disagreement between old and new members of the management over the plan's contents was not enough to satisfy the "clear abuse" standard. After a proxy fight, a group of preferred shareholders elected five out of eleven directors.

The resolution of this issue in a particular case may depend upon which court hears and decides the issue. Depending on whether the corporate governance issues are considered to be "core" or "non-core" matters in the local jurisdiction, they will be decided by either the bankruptcy or a higher federal court. Perhaps because bankruptcy courts are more attuned to the chapter 11 process and to the goal of preserving the estate for the benefit of all constituencies, they tend to be more willing to restrict shareholders' meetings.ⁿ⁹

[b] Purchasing Claims.

[i] Control of Classes of Creditors.

As it can outside of bankruptcy, an investor who finds itself with a claim in a chapter 11 case may be able to obtain control of the debtor by obtaining a holdout position. In bankruptcy, however, the Bankruptcy Code provides investors with a certain degree of additional leverage against the debtor to gain control. *Section 1126(c) of the Bankruptcy Code* requires that, absent a cramdown, a plan of reorganization must be approved by a vote of the holders of two-thirds in amount and more than one-half in number of allowed claims of those voting in each class. Thus, an acquiror may attempt to gain control of the debtor by purchasing sufficient claims to control one or more classes of creditors and thereby control the voting of the plan, effectively forcing approval of a plan that includes its acquisition of the debtor. Unlike in a workout, where a holdout's position might be weakened by the management's ability to lower the minimum votes required to approve a plan or to turn to other alternatives (such as bankruptcy itself) in face of the holdout, achieving a blocking position in the voting of a plan of reorganization can be a very effective instrument in obtaining control.

Some commentators, however, have raised the question as to whether it is possible to control the vote of a class without buying every claim in that class.ⁿ¹⁰ Despite the voting requirements set forth in *section 1126(c) of the Bankruptcy Code*, the issue of how to count votes when one creditor acquires the claims of others remains unsettled. It can be argued, given the precedents under the Bankruptcy Act of 1898 (the "Act")ⁿ¹¹ and the language of section 1126(c), that the purchaser of multiple claims will be counted as having only one vote on a plan of reorganization.ⁿ¹² Therefore, an acquiror of claims may find itself in the anomalous position of having an increasingly large percentage of the amount of the claims, but never obtaining the requisite number of claims until the last member of the class sells. Such acquiror may not be able to circumvent this anomalous result by assignments to friendly parties: assignments of claims solely for the purpose of manipulating the number of creditors have been ruled void by the courts.ⁿ¹³

[ii] Procedural Requirements.

Investors who seek to acquire claims and equity interests in a troubled company after it has filed a chapter 11 petition must satisfy procedural requirements imposed by Bankruptcy *Rule 3001(e)*.

Any trade of a claim (other than a publicly-traded debt security) must comply with the requirements of *Rule 3001(e)*. The requirements vary depending on whether the claim has been transferred before or after a proof of claim has been filed. In both cases, the requirements are ministerial. If the claim has been transferred (other than for security) before a proof of claim has been filed, the proof of claim can only be filed by the transferee. If, however, the claim has been transferred (other than for security) after a proof of claim has been filed, the transferee must notify the clerk of the bankruptcy court of the transfer (but is not required to disclose its terms); the clerk then notifies the alleged transferor and, if the transferor does not object within 20 days, replaces the transferor with the transferee on the court's records as the holder of the claim. The seller of the claim is the only party with standing to object to the transfer of the claim; absent such objection, the consideration paid for such transfer should not be subject to judicial scrutiny. However, even if the debtor may not be able to object to the transfer itself, it (or a creditors' committee) may try to solicit objections from the seller of the claim.

Amended in 1991, *Rule 3001(e)* was intended to limit the role of bankruptcy courts in the claim-trading process.ⁿ¹⁴ Prior to 1991, the transfer of a claim after a proof of claim had been filed required court approval, after notice and a hearing. The pre-1991 notice and hearing requirement provided courts with an opportunity to review, and third parties (including the debtor) with an opportunity to object to, the fairness of a proposed trade. By contrast, under the current rule, courts will only become involved if the transferor of a claim objects to the proposed transfer.

Notwithstanding *Rule 3001(e)*, certain commentators have noted that a court can still regulate claims trading through its general injunctive powers granted under *section 105(a) of the Bankruptcy Code*, or pursuant to *section 510(c), 1123(a)(4), 1125(b) or 1126(e) of the Bankruptcy Code*.ⁿ¹⁵ Certain restrictions on claim trading imposed by courts relying on these sections prior to the 1991 amendment are discussed below. In addition, *Rule 3001(e)* does not eliminate remedies available to the two parties to the claim transfer under non-bankruptcy law, including securities laws.ⁿ¹⁶

[iii] "Good Faith" Requirement.

Section 1126(e) of the Bankruptcy Code raises the possibility that the vote of a potential acquiror that has achieved a blocking position may be challenged and disregarded when the plan is confirmed by the court. This may occur for several reasons.

Section 1126(e) provides that the bankruptcy court may "designate any entity whose acceptance or rejection of [a] plan was not in good faith. ..." ⁿ¹⁷ A vote so designated would not be counted by the court in determining whether the plan was approved by a particular class, thereby removing the potential acquiror's blocking position.ⁿ¹⁸

The term "good faith" is not defined in the Bankruptcy Code, giving each court facing the issue wide latitude in formulating a response to the particular facts before it.ⁿ¹⁹ However, courts considering *section 1126(e)* and similar provisions in the Act have fashioned a general rule that a vote of a creditor is not in good faith if it is made for reasons other than its interest as a creditor.ⁿ²⁰ The general rule does not provide much guidance, but one can glean from the few cases in the area two general applications of this rule. First, if a member of a class uses its voting power to extract treatment for itself different from that of the other members of the class, the member's vote may be set aside. Second, a court will focus on the motives behind the purchaser's vote.

[A] Prohibition on Preferential Treatment

Bankruptcy laws do not allow "greenmail": an investor with a blocking position cannot capitalize on that position to receive treatment more favorable than the rest of the creditors in its class.ⁿ²¹ Therefore, such investor cannot receive more than the rest of its class by selling its position to those interested in the success or failure of a plan. Courts have refused, for example, to allow a vote change where a creditor, after first objecting to a plan, switched its vote after receiving a pay-off from the plan proponent.ⁿ²² A vote made after a sale of claims to a potential acquiror on terms

more favorable than those offered to creditors who remain in the reorganization case may also be in bad faith. In *In re P-R Holding Corp.*,ⁿ²³ the selling creditors received cash; under the plan, existing creditors received only securities. The court reasoned that the purchases discriminated in favor of the selling creditors and, thus, the subsequent vote by the purchaser was not made in good faith.ⁿ²⁴

[B] Motives Behind Vote

Courts also focus on the motives behind the vote of the blocking creditor:

The test is plainly to be sought in the motives of the holder of the claims. The Securities and Exchange Commission suggests in its brief that if assent is withheld to serve some ulterior selfish purpose good faith is wanting. If the emphasis be placed on "ulterior" rather than "selfish" this seems to be as practical a test as could be found. What is selfishness from the standpoint of those who derive no benefit from conduct under scrutiny often becomes enlightened self-interest if viewed from the standpoint of those who gain by it. If a selfish motive were sufficient to condemn reorganization policies of interested parties, very few, if any, would pass muster. On the other hand, pure malice, "strikes" and blackmail, and purpose to destroy an enterprise in order to advance the interests of a competing business, all plainly constituting bad faith, are motives which may be accurately described as ulterior.ⁿ²⁵

A vote cast for "ulterior reasons" would, therefore, be set aside, while one based merely on the self-interest of the creditor would be considered valid by the bankruptcy court.ⁿ²⁶ While this test rests on the equitable considerations of each case actually before the court, the distinction, if one can be made, between an "ulterior motive" and a "selfish interest" appears to be the identity of that interest with other interests in the creditor's class.ⁿ²⁷ A creditor that has submitted a bid to acquire a debtor may vote for a plan that incorporates the acquisition, so long as it also favors its investment represented in the class.ⁿ²⁸

However, in *In re Allegheny International, Inc.*,ⁿ²⁹ the court disqualified the votes of Japonica Partners, which was in the process of attempting to obtain control of the debtor through a hostile tender offer.

It is worthwhile to consider this decision in detail since, as commentators have pointed out,ⁿ³⁰ it marked a turning point in the law governing acquisitions in chapter 11 cases.

Japonica made two proposals to acquire Allegheny International, Inc. Allegheny did not seriously consider these proposals and on December 29, 1989, it filed its own plan and related disclosure statement. This plan, among other things, amended Allegheny's charter by adding a "Control Transaction" provision, colloquially known as a "poison put," to make any attempt at a tender offer for the stock of Allegheny prohibitively expensive. In response, Japonica filed its own plan and related disclosure statement.

In the following months, Japonica purchased enough claims to be in a position to block the approval of the debtor's plan, paying for some of these claims more than their holders were entitled to receive under Japonica's own plan.ⁿ³¹

Japonica then commenced a cash tender offer for all subordinated debentures of Allegheny comprising yet another class, as well as the debentures of an Allegheny subsidiary. In the middle of the tender offer, the court approved Japonica's disclosure statement and plan. Immediately before the balloting on its plan, Japonica purchased a significant amount of senior unsecured claims for cash prices significantly in excess of the distribution offered to the relevant class under Japonica's plan.

At the close of the balloting on Japonica's plan, neither the debtor's nor Japonica's plan had enough votes to win and both sides filed motions to disqualify the votes supporting the other's plan. The court disqualified Japonica's votes not because they were deemed to be in "bad faith."ⁿ³²

The court also found that Japonica violated *section 1123(a)(4) of the Bankruptcy Code* by acquiring claims at prices different from those promised under its plan.

The lessons to be learned from *Allegheny* seem to be as follows: (i) the courts may find "ulterior motive"/bad faith in the acquiror's actions when the acquisition of claims is aimed primarily at obtaining control of the reorganized debtor; and (ii) when purchases are made by an investor in contemplation of or in furtherance of a plan of reorganization, such purchases will be viewed as part of the plan.ⁿ³³ The investor may not be able to purchase claims cheaply because the early sellers will attempt to share in any premium obtained by the later sellers. To purchase claims cheaply, an investor would have to do so well in advance of any plan and thus share in all of the risks of the reorganization process.

Commentators have noted that while *Allegheny* is often cited, attempts to disqualify a creditor's vote on a plan of reorganization on the basis that it was cast in bad faith or with an ulterior motive are not automatically successful.ⁿ³⁴ As a general matter, courts continue to hold that creditors can vote purchased claims against a plan that they believe is contrary to their interests. The decision of the Court of Appeals for the Ninth Circuit in *In re Figter Ltd.* ⁿ³⁵ illustrates how courts have sought to define more precisely the circumstances under which votes of claims purchasers can be disqualified in this context. In that case, the court noted that "the mere fact that a creditor has purchased additional claims for the purpose of protecting its own existing claim does not demonstrate bad faith or an ulterior motive" and stressed "the difference between a creditor's self interest as a creditor and a motive which is ulterior to the purpose of protecting a creditor's interest."ⁿ³⁶

[iv] Solicitation and Disclosure Requirements.

A potential acquiror of a troubled company should be mindful of solicitation and disclosure requirements of the Bankruptcy Code and state and federal securities laws. The various requirements may be imposed in connection with the acquisition of the claim by the acquiror, its negotiations with the troubled company, and its solicitation of votes in favor or against the plan of reorganization, although not all of the laws may be applicable in each of the above instances.

[A] Purchase of Registered Securities

If the investor chooses to bid for control of the troubled company by acquiring its equity securities, and if such securities are registered under section 12 of the Securities Exchange Act of 1934, as amended (the "1934 Act"),ⁿ³⁷ the investor must comply with the SEC rules regulating tender offers. Even though purchases of securities in open-market transactions or from a limited number of sophisticated investors are likely not to qualify as a tender offer,ⁿ³⁸ it is prudent to consider the existing guidelines of what constitutes a tender offer before embarking on any large scale purchase program.

Neither the 1934 Act nor SEC rules promulgated under it define the term "tender offer." Courts have applied several different tests to determine whether a purchase plan constitutes a tender offer.ⁿ³⁹ The most frequently cited test is the eight-factor test proposed by the SEC and cited with approval in *Wellman v. Dickinson*.ⁿ⁴⁰ The eight factors are:

- (1) An active and widespread solicitation of public shareholders is made for shares of the issuer;
- (2) Solicitation is made for a substantial percentage of the issuer's stock;
- (3) The offer to purchase is made at a premium above the prevailing market price;
- (4) The terms of the offer are firm, rather than negotiable;
- (5) The offer is contingent on the tender of a fixed minimum number of shares and is often subject to a ceiling of a fixed maximum number of shares to be purchased;

- (6) The offer is open for only a limited period of time;
- (7) Offerees are subject to pressure to sell their stock; and
- (8) Public announcements of an acquisition program precede or accompany the accumulation of stock.

Many courts have moved away from relying exclusively on the *Wellman* factors, however. The Second Circuit, in *Hanson Trust PLC v. SCM Corp.*,ⁿ⁴¹ cautioned against using the *Wellman* factors as a "mandatory litmus test," and many courts have followed suit.ⁿ⁴² The court in *Hanson* instead asked whether there was "a substantial risk that solicitees will lack information needed to make a carefully considered appraisal of the proposal put before them" and "whether the particular class of persons needs the protection of the Act."ⁿ⁴³

If a stock acquisition program is found to constitute a tender offer, the 1934 Act would subject the bidder to certain filing, disclosure and other requirements.ⁿ⁴⁴ While no separate filing or disclosure requirements apply when the offer is for debt securities only,ⁿ⁴⁵ the investor making a tender offer for any security must comply with section 14(e) of the 1934 Act, which requires full and accurate disclosure about the tender offer. Regulation 14E sets forth the timing and anti-fraud provisions to which all tender offers are subject, whether they are for equity or debt securities.ⁿ⁴⁶ Additionally, the anti-fraud provisions of section 10(b) of the 1934 Act and of *Rule 10b-5* promulgated thereunder apply to purchases of securities, whether or not such purchases constitute a tender offer.ⁿ⁴⁷

[B] Acquisition of Claimer that are not Publicly Traded

If, however, the investor seeks to acquire claims other than publicly-traded equity or debt securities (such as bank or trade debt), the investor should still take note of state and federal securities laws, even though they have not been historically applied to bankruptcy claims.ⁿ⁴⁸

With very few exceptions, federal courts have chosen not to include bankruptcy claims in the definition of "security."ⁿ⁴⁹ However, because of the lack of a bright line rule defining precisely what the limits of the definition of "security" are and the potential for abuse in the largely unregulated trading of bankruptcy claims,ⁿ⁵⁰ there is a possibility that bankruptcy claims could be considered securities, at least in some cases.

Even if bankruptcy claims are considered securities, their acquisition and resale outside the securities market, especially acquisitions from institutional investors, would ordinarily be exempt from the 1933 Act under section 4(2) (the private placement exemption)ⁿ⁵¹ or Regulation D.ⁿ⁵² They would, however, remain subject to the proxy and anti-fraud provisions of the 1934 Act.ⁿ⁵³

Once the company has filed for bankruptcy, bankruptcy and securities laws begin to intersect in regulating the conduct of the acquiror of claims. Solicitations of acceptances and rejections of a chapter 11 reorganization plan, which provides for the issuance of securities to holders of claims against or interests in the debtor, are subject to the requirements of section 14(a) of the 1934 Act, as well as to *section 1125 of the Bankruptcy Code*.

Section 1125(b) requires that all solicitations must be preceded by the distribution of a court-approved disclosure statement, and section 1125(e) provides a "safe-harbor" from the requirements of the securities laws if such court-approved disclosure statement is used and the Bankruptcy Code's solicitation requirements are followed.ⁿ⁵⁴ Under section 1125(e), solicitations of acceptances or rejections of plans, made in good faith, or participations in good faith in offers or sales of securities offered or sold under such plans, are exempt from federal and state securities laws. The section is intended to provide a "safe-harbor" from securities law anti-fraud rules for creditors' committees and creditors soliciting votes or otherwise participating in a plan. Without it, a creditor that solicited a vote on the plan in reliance on the court's approval of a disclosure statement would be potentially liable under the anti-fraud provisions

designed to enforce the securities regulations from which section 1125(d) specifically excuses compliance.

Section 1125(e) also codifies the standard that the Supreme Court adopted in *Ernst & Ernst v. Hochfelder*,ⁿ⁵⁵ which requires proof of "scienter" as a condition to liability under *Rule 10b-5*.ⁿ⁵⁶ The safe-harbor applies to participations in offers or sales of securities issued by the debtor, an affiliate participating under the plan, or successors to the debtor.ⁿ⁵⁷ However, while the section provides a safe-harbor for actions conducted in "good faith," a term undefined in the Bankruptcy Code but one that would surely exclude dissemination of misleading information, the SEC has warned that acts not in good faith will be subject to the penalties prescribed by the federal securities laws.ⁿ⁵⁸

It is not entirely clear whether the bankruptcy or the securities laws govern claims purchases that occur postpetition, but before a reorganization plan is filed. But it is important to note that courts have been known to consider widespread acquisitions of claims a "solicitation" of plan votes if, as a result, the acquiror obtains significant control over the plan process and particularly if the acquiror is preparing to become a plan proponent.ⁿ⁵⁹ In the extreme cases, such as when the purchases are so great in number that they amount to a plan of reorganization, courts may refuse to permit the transfer of the claims until sufficient disclosure is given.ⁿ⁶⁰

Once a claim is acquired, the acquiror may be restricted in its negotiations with other creditors and the debtor to obtain control, if such negotiations are deemed to be a "solicitation" of votes requiring adequate disclosure pursuant to *section 1125 of the Bankruptcy Code*. However, in practice, before a disclosure statement is approved by the court, the debtor and its principal creditors conduct extensive negotiations over the terms of the reorganization plan. Courts have given parties wide latitude to undertake such negotiations without requiring that materials be delivered that satisfy section 1125.ⁿ⁶¹

Even if section 1125 disclosure requirements may not apply (for instance, if it is unclear whether an acquisition of claims is a "solicitation" of plan votes), acquirors may still wish to use court-approved disclosure statements in accordance with section 1125 and thus benefit from the safe-harbor protections. In one case, a transfer of claims was approved by the court where the acquiror used the court-approved solicitation statement.ⁿ⁶²

[C] Offer and Sale of Plan Securities

If an investor receiving securities issued pursuant to a plan of reorganization under *section 1145(a)(1) of the Bankruptcy Code* (the "plan securities") does not come within the definition of "underwriter" contained in section 1145(b)(1), section 1145(b)(3) will allow the investor to resell the plan securities without registration under the 1933 Act.ⁿ⁶³

Section 1145(b)(3) provides that a reselling investor is not regarded as an "underwriter," for purposes of the 1933 Act, with respect to the offer and resale of the plan securities. Accordingly, an investor may resell the plan securities without registration in reliance on the exemption in section 4(1) of the 1933 Act.ⁿ⁶⁴

Securities are often offered under a plan to creditors who have already decided to resell them after the plan is confirmed. Such a "view to distribution" technically pulls such creditors into the status of "underwriter" under section 2(11) of the 1933 Act.ⁿ⁶⁵ However, *section 1145(b) of the Bankruptcy Code* narrows the definition of "underwriter" to carve out these "technical" underwriters from resale restrictions while maintaining their applicability to "real" underwriters,ⁿ⁶⁶ including those investors in pre-plan securities who intend to resell them (or any securities issued under the plan) after the plan is confirmed.

Section 1145(b)(1) defines an "underwriter" as one who:

(A) purchases claims or interests (as opposed to the securities later issued therefor) with a view to distribution of any security received in exchange therefor;

(B) offers to sell securities offered or sold under the plan for the holders of these securities;

(C) offers to buy securities offered or sold under the plan from the holders of these securities, if the offer to buy is (1) made with a view to distribution of these securities, and (2) pursuant to an agreement made in connection with the plan, its consummation or the offer or sale of securities under the plan; or

(D) is an issuer, as used in section 2(11) of the 1933 Act (*15 U.S.C. § 77b(11)*), with respect to these securities.ⁿ⁶⁷

An investor that comes within the section 1145(b)(1) definition of "underwriter" (but is not an "issuer") can only resell the plan securities (a) pursuant to an effective registration statement; (b) pursuant to an available statutory exemption (such as section 4(2) of or Regulation D under the 1933 Act); or (c) in the course of "ordinary trading transactions."

The parameters of the "ordinary trading transactions" exemption have been outlined by the SEC in a no-action letter given to Manville Corporation.ⁿ⁶⁸ According to this letter, if the issuer is a "1934 Act reporting company"ⁿ⁶⁹ and the resales occur through an exchange or the over-the-counter market, a person who may have otherwise qualified as an "underwriter" under section 1145(b) will be considered to be engaged in exempt "ordinary trading transactions" so long as none of the following factors are present:

- (1) concerted action by or on behalf of recipients of the plan securities in connection with the sale;
- (2) use of special selling documentation; or
- (3) special compensation to the selling brokers or dealers.

Resale pursuant to the "ordinary trading transactions" exemption is allowed even when arrangements with broker-dealers and market makers are made prior to the distribution of plan securities to facilitate such resale.ⁿ⁷⁰

[3] Funding a Plan of Reorganization.

[a] In General.

A potential investor may purchase a distressed company by making a capital contribution to the reorganized debtor as part of a plan of reorganization that gives the purchaser all or most of the equity in the reorganized debtor in exchange for its capital contribution.ⁿ⁷¹ The purchaser and plan proponent (usually the debtor or an official creditors' committee) must go through the entire plan of reorganization process before the acquisition is complete. This process is generally more time- and labor-consuming than an asset sale.ⁿ⁷² The plan proponent also faces the risks accompanying a plan of reorganization and the transaction will be subject to higher or better bids. Further, objections may be received from the official creditors' committee, secured and unsecured creditors or the United States Trustee, and the bankruptcy judge may raise his or her own concerns.

[b] DIP Financing.

Another way to effectively gain control over the debtor or the reorganization process by combining debtor in possession ("DIP") or postpetition financing pursuant to *section 364 of the Bankruptcy Code* with a plan of reorganization or an asset sale.ⁿ⁷³

In *ICO Global Communications Services, Inc.* ⁿ⁷⁴ the debtors needed \$1.2 billion to achieve a full launch of their satellites in order to become operational, in addition to the \$3.4 billion they had spent before their bankruptcy filing. Eagle River Investments LLC and other entities affiliated with Craig O. McCaw (collectively, the "Strategic Investor")

agreed to finance the remaining cost through \$500 million in DIP financing and \$700 million in exit financing. In consideration, the plan of reorganization converted the \$500 million DIP financing into 40.5% of the outstanding shares of the reorganized debtor and the \$700 million in exit financing converted into 34.5% of the outstanding shares of the reorganized debtors.

The plan of reorganization was negotiated with the Strategic Investor subsequent to the bankruptcy filings. The terms and conditions of the plan were filed as an exhibit to the credit agreement in connection with the financing. Events of default in the credit agreement included the debtor's filing of a plan other than the plan negotiated with the Strategic Investor, the debtor's failure to file a plan within four months after the commencement of the case, and the debtor's failure to reach the effective date within approximately ten months after the commencement of the case. If an event of default occurred, the Strategic Investor had the right to demand the payment of all loans and interest, and after five days, seize the collateral (i.e., all the property, tangible or intangible, of the debtors). The credit agreement was approved by the bankruptcy court and the transaction was consummated.

In *Transworld Airlines, Inc.*,⁷⁵ the debtor combined an asset sale pursuant to *section 363 of the Bankruptcy Code*⁷⁶ with a DIP financing. Shortly before filing, Transworld Airlines ("TWA") and American Airlines ("AMR") entered into an asset purchase agreement that provided for AMR's purchase of all of TWA's assets and assumptions of a significant portion of its liabilities, including employee-related obligations. AMR also agreed to provide \$200 million in DIP financing to TWA, secured by a first lien on all unencumbered assets and a junior lien on all encumbered assets of TWA. Events of default in the credit agreement included the following events: (i) the thirtieth day following the termination of the asset purchase agreement by AMR; (ii) the termination of the asset purchase agreement by TWA; (iii) the tenth day following the approval of a sale to another party by TWA's board of directors; and (iv) the bankruptcy court's entry of an order approving a sale of TWA to another party. The bankruptcy court approved the credit agreement and ultimately the sale of TWA's assets to AMR.

FOOTNOTES:

(n1)Footnote 1. This tactic may not always work. Even though the Bankruptcy Code is liberal in defining the parties that may force the company into bankruptcy (*see 11 U.S.C. § 303*), it gives the bankruptcy court discretion to dismiss an involuntary case if "the interests of creditors and the debtor would be better served by such dismissal... ." *11 U.S.C. § 305(a)(1)*. The legislative history of the section indicates that this should be used when an out-of-court settlement is at hand, and only the actions of a holdout investor are forcing the bankruptcy. *See H.R. Rep. No. 595, 95th Cong., 1st Sess. 325 (1977), reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised)* (a case should be dismissed if "an arrangement is being worked out by creditors and the debtor out of court, there is no prejudice to the rights of creditors in that arrangement, and an involuntary case has been commenced by a few recalcitrant creditors to provide a basis for future threats to extract full payment").

(n2)Footnote 2. For a discussion of the risks associated with investing in a troubled company, *see P7.04 infra*.

(n3)Footnote 3. For a discussion of the shift in fiduciary duties of directors when the company becomes insolvent, *see ch.3 supra*.

(n4)Footnote 4. *See Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.)*, 801 F.2d 60, 64, 15 C.B.C.2d 645, 650 (2d Cir. 1986) .

(n5)Footnote 5. *In re Johns-Manville Corp.*, 801 F.2d 60, 15 C.B.C.2d 645 (2d Cir. 1986) .

(n6)Footnote 6. 801 F.2d 60, 69, 15 C.B.C.2d 645, 656 .

(n7)Footnote 7. *In re Johns-Manville Corp.*, 66 B.R. 517 (Bankr. S.D.N.Y. 1986) . *See also In re American Media Distributors, LLC*, 216 B.R. 486, 489 (Bankr. E.D.N.Y. 1998) (bankruptcy court likened the use of arbitration to resolve dispute over management rights in a debtor to the exercise of governance rights by shareholders of a debtor corporation

and thus held that the automatic stay did not enjoin their rights to participate in the governance of the business in which they owned equity interests); *In re Lionel Corp.*, 30 B.R. 327, 330 (Bankr. S.D.N.Y. 1983) (bankruptcy court declined to enjoin state court action brought to compel corporation to hold a shareholders' meeting, since there was no evidence that reorganization proceedings would be thwarted by permitting the shareholders' meeting to be held); *Official Bondholders Comm. v. Chase Manhattan Bank (In re Marvel Entertainment Group, Inc.)*, 209 B.R. 832, 838 (Bankr. D. Del. 1997) (bankruptcy courts may not deny a shareholder's right to compel a meeting to elect new directors without a showing of "clear abuse").

(n8)Footnote 8. No. 88-1101 (W.D. Pa. May 31, 1988).

(n9)Footnote 9. *See, e.g., In re Allegheny International, Inc.*, n.8 *supra*, slip op. at 6-8:

This court is very troubled by the expenditures for the proxy battle. Neither management nor the election Committee can assert that (1) the proxy expenditures "are in the ordinary course of business" and (2) that they benefit the bankruptcy estate of the debtor. At best they are partisan expenditures that reduce the estate available for unsecured creditors and will have an unknown result on the final reorganization.

(n10)Footnote 10. Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 *Cardozo L. Rev.* 1, 86 (1990) ["Fortgang & Mayer"].

(n11)Footnote 11. *See, e.g., In re Messengill*, 113 F. 366 (D.N.C. 1902) .

(n12)Footnote 12. *See e.g., In re Gilbert*, 115 B.R. 458, 461 (Bankr. S.D.N.Y. 1990) (holding that for purposes of section 303(b)(1), which requires that an involuntary petition be filed by three or more entities, a successor to the claims of three creditors was "one creditor [with] three separate claims"); *In re Moss*, 249 B.R. 411, 421 (Bankr. N.D. Tex. 2000) (finding that two creditors held just one "claim" for purpose of filing an involuntary petition where, under Texas law, the debtor's liability to the creditors was joint not several). *But see In re Gilbert*, 104 B.R. 206, 211 (Bankr. W.D. Mo. 1989) (adjudging holder of two claims to have two votes, without any analysis of prior cases).

(n13)Footnote 13. *See, e.g., In re Latham Lithographic Corp.*, 107 F.2d 749, 751 (2d Cir. 1939) ; *Leighton v. Kennedy*, 129 F. 737, 741 (1st Cir. Mass. 1904) .

(n14)Footnote 14. 1991 Advisory Committee Note to *Fed R. Bankr. P. 3001(e)(2)*.

(n15)Footnote 15. *See* Michael H. Whitaker, *Regulating Claims Trading in Chapter 11 Bankruptcies: A Proposal for Mandatory Disclosure*, 3 *Cornell J.L. & Pub. Pol'y* 303, 322 (1994); Andrew P. Logan III, *Claims Trading: The Need for Further Amending Federal Rule of Bankruptcy Procedure 3001(E)(2)*, 2 *Am. Bankr. Inst. L. Rev.* 495, 503 (1994); Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws?*, 10 *Am. Bankr. Inst. L. Rev.* 569, 577-93 (2002) ["Drain & Schwartz"]. *See also In re Pleasant Hill Partners, L.P.*, 163 B.R. 388, 391 (Bankr. N.D. Ga. 1994) (stating that in the wake of Rule 3001(e) parties must "rely primarily upon §§ 1125(b), 1126(e) and 105, as well as pre-Code law, for the authority of the bankruptcy court to regulate trading claims").

(n16)Footnote 16. *See P 7.03[2][b][iv] infra*.

(n17)Footnote 17. 11 U.S.C. § 1126(e).

(n18)Footnote 18. 11 U.S.C. § 1126(c), (d).

(n19)Footnote 19. For a summary of the common law development of the "good faith" requirement, *see, e.g., Fighter Ltd. v. Teachers Ins. & Annuity Ass'n of Am. (In re Fighter Ltd.)*, 118 F.3d 635, 638-39, *cert. denied*, 522 U.S.

996, 118 S. Ct. 561, 139 L. Ed. 2d 402 (1997) .

(n20)Footnote 20. See, e.g., *In re P-R Holding Corp.*, 147 F.2d 895, 897 (2d Cir. 1945) .

(n21)Footnote 21. "The history of [predecessor to section 1126(e)] makes clear that it was intended to apply to those stockholders whose selfish purpose was to obstruct a fair and feasible reorganization in the hope that someone would pay them more than the ratable equivalent of their proportionate share of the bankrupt assets." *Young v. Higbee Co.*, 324 U.S. 204, 211, 65 S. Ct. 594, 598, 89 L. Ed. 890, 896-97 (1945) . See also *In re Adelphia Communications Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (citing *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844-845 (Bankr. S.D.N.Y. 1995)) (requisite bad faith can be satisfied where a creditor (i) attempts to extract or extort a personal advantage not available to other creditors in the class or (ii) acts in furtherance of an ulterior motive, unrelated to its claim or its interests as a creditor).

(n22)Footnote 22. See, e.g., *In re Featherworks Corp.*, 25 B.R. 634, 640-41 (Bankr. E.D.N.Y. 1982) , *aff'd*, 10 C.B.C.2d 212, 36 B.R. 460 (E.D.N.Y. 1984) ; *In re Fuller Cleaning & Dyeing Co.*, 118 F.2d 978, 979 (6th Cir. 1941) .

(n23)Footnote 23. 147 F.2d 895 (2d Cir. 1945) .

(n24)Footnote 24. 147 F.2d 895, 898 . But see *In re Frank Fehr Brewing Co.*, 268 F.2d 170 (6th Cir. 1959) (Court of Appeals for the Sixth Circuit upheld a cramdown plan which issued first mortgage bonds to a class of creditors, even though the group funding the plan and acquiring control of the debtor had purchased claims of certain creditors in that class who had objected to the plan at 80 cents on the dollar, in cash), *cert. denied*, 362 U.S. 963, 80 S. Ct. 880, 4 L. Ed. 2d 878 (1960) .

(n25)Footnote 25. *In re Pine Hill Collieries Co.*, 46 F. Supp. 669, 671 (E.D. Pa. 1942) .

(n26)Footnote 26. For example, votes by a competitor who is also a creditor "for the ulterior purpose of destroying or injuring debtor in its business so that the interests of the competing business [of the creditor] ... could be furthered" were considered to be in bad faith. *In re MacLeod Co., Inc.*, 63 B.R. 654, 655-56 (Bankr. S.D. Ohio 1986) ; see also *In re Beugen*, 99 B.R. 961 (B.A.P. 9th Cir. 1989) , *aff'd without op.*, 930 F.2d 26 (9th Cir. 1991) (person who purchased claims against the debtor solely for the purpose of harassing the debtor was not acting in good faith) ; *In re Adelphia Communications Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (citing *In re Dune Deck Owners Corp.*, 175 B.R. 839, 844-845 (Bankr. S.D.N.Y. 1995)) ("badges" of bad faith include votes designed to (1) assume control of the debtor; (2) put the debtor out of business or otherwise gain a competitive advantage; (3) destroy the debtor out of pure malice; or (4) obtain benefits available under a private agreement with a third party which depends on the debtor's failure to reorganize). However, a vote cast against a plan by a creditor hoping that rejection of the plan may bring an end to a suit in which it was the defendant was not deemed to be in bad faith. See *In re Federal Support Co.*, 859 F.2d 17, 20 (4th Cir. 1988) ; *In re Mikulec Indus., Inc.*, 1992 U.S. Dist. LEXIS 10432 (W.D.N.Y. July 13, 1992) . See also *Three Flint Hill Ltd. P'ship v. Prudential Ins. Co. (In re Three Flint Hill Ltd. P'ship)*, 213 B.R. 292, 301 (D. Md. 1997) (holding that a creditor who purchased claims of smaller creditors so that it could block the debtor's reorganization plan and who, as the only impaired creditor, voted to confirm its own liquidation plan, did not act in bad faith).

(n27)Footnote 27. See *In re Lehigh Valley Professional Sports Clubs, Inc.*, 2001 WL 1188246, at *6 (Bankr. E.D. Pa. Sept. 7, 2001) (while a creditor is expected to act in its own self-interest and, thus, that alone is not bad faith, a creditor who has voted against a plan in order to gain an advantage over other unsecured creditors has voted for an ulterior motive, but a creditor's vote against a plan because its centerpiece was a suit against it is not alone sufficient to find bad faith).

(n28)Footnote 28. See *In re Frank Fehr Brewing Co.*, note 24 *supra*, 268 F.2d 170, 180(6th Cir. 1959); see also *Mokava Corp. v. Dolan*, 147 F.2d 340, 344 (2d Cir. 1945) (votes issued in contests of control for a plan that is beneficial to creditors are not deemed to be made in bad faith); *In re First Humanics Corp.*, 124 B.R. 87 (Bankr. W.D. Mo. 1991) (a creditor is acting in good faith as long as its motives are compatible with promoting the reorganization

process).

(n29)Footnote 29. *118 B.R. 282 (Bankr. W.D. Pa. 1990)* .

(n30)Footnote 30. Fortgang & Mayer, *Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, 13 *Cardozo L. Rev.* 1, 20 (1991) ["Fortgang & Mayer II"]; see also *id.* at 20-33 for a detailed reconstruction of the facts in *Allegheny*, n.28 *supra* ; Lieb, *Vultures Beware: Risks of Purchasing Claims Against a Chapter 11 Debtor*, 48 *Bus. Law.* 915 (1993).

(n31)Footnote 31. At the same time, Allegheny's management apparently arranged for the sale of bank claims to a friendly syndicate of investors. The syndicate offered to pay 101.1 cents per dollar of claim for the bank's stock when issued. The agreement did not require the banks to vote for the debtor's plan, but conditioned its offer on the debtor's plan being confirmed. The banks that signed the agreements with the syndicate voted for Allegheny's plan, as did the banks that neither signed the agreement nor sold their claims to Japonica. *Fortgang & Mayer II*, n.29 *supra*, at 25.

(n32)Footnote 32. Japonica was also deemed to be an "insider" by virtue of its access to inside information in the process of conducting due diligence as a plan proponent. Japonica's influence over certain decisions made by the debtor's management combined with the access to "information that was not available to other creditors, shareholders and the general public," made Japonica, as a matter of law, "an insider and a fiduciary for the purpose of [Allegheny's] reorganization." *118 B.R. 282, 298, 299* . Discussing this aspect of the *Allegheny* decision, Fortgang & Mayer point out that the future claim acquirors may run the risk of being considered "insiders" by virtue of the Bankruptcy Code "affiliate" provision. The definition of "insider" in *section 101 of the Bankruptcy Code* includes "affiliates," and an "affiliate" includes any party holding 20% of the voting stock of the debtor. As soon as the investor acquires enough claims to entitle it to receive more than 20% of the debtor's stock under the reorganization plan, its vote may be disqualified as that of an "insider." See *Fortgang & Mayer II*, n.29 *supra*, at 44.

(n33)Footnote 33. See *In re Applegate Prop., Ltd.*, 25 *C.B.C.2d* 1672, 133 *B.R. 827 (Bankr. W.D. Tex. 1991)* . In *Applegate*, an affiliate of the debtor purchased enough claims to block the confirmation of the plan proposed by the Resolution Trust Corporation (the "RTC") and to ensure the confirmation of the debtor's plan. The acquiror testified that it had purchased claims solely to prevent the RTC from doing the same. The court, citing *Allegheny*, n.28 *supra* , stated that such purpose "will not withstand the 'good faith' hurdle imposed by Section 1126(e)." 133 *B.R. at* 835, 25 *C.B.C.2d at* 1683 . See also *In re Lloyd McKee Motors, Inc.*, 157 *B.R. 487, 488-89 (Bankr. D.N.M., 1993)* (the purpose of the good faith provision is to prevent creditors from employing "obstructive tactics and holdup techniques" to get some unfair advantage through the plan's acceptance or rejection, or to get preferred treatment for the price of their vote. But see *In re Mid-State Raceway, Inc.*, 2005 *Bankr. LEXIS* 2920, at *19-21 (distinguishing *Allegheny* and *Applegate* by finding that although the purchase of a claim blocked the confirmation of a competing plan, the purchase of the claim and vote against the competing plan were not done in bad faith because the purchase also resulted in a settlement of the claim in furtherance of the plan proposed by the purchaser and the debtor when efforts towards settlement "arguably would have occurred even in the absence of a competing plan"); *Principal Mut. Life Ins. Co. v. Lakeside Assocs., L.P. (In re DeLuca)*, 194 *B.R. 797, 805 (Bankr. E.D. Va. 1996)* (distinguishing *Applegate* by finding no basis to disqualify the unsecured claims purchased by the largest unsecured creditor as having been voted in bad faith, where the debtor's proposed plan would make such creditor an involuntary lender to the debtor for the next seven years); *In re Marin Town Center*, 142 *B.R. 374 (N.D. Cal. 1992)* (reversing the bankruptcy court's disqualification of the acquiror's votes based on *Allegheny*; the district court distinguished *Allegheny* by pointing out that the acquiror (1) had a legitimate economic interest to ensure the defeat of the debtor's plan; (2) was not itself a proponent of a competing plan; and (3) had bought the bulk of the claims before the debtor's plan was proposed); *In re Micron Prods., Inc.*, 1992 *Bankr. LEXIS* 1514, *7 (Bankr. E.D. Pa. Sept. 28, 1992) (refusing to follow *Allegheny*, and calling its holding "fact driven" and one that "should not be broadly applied to all participants in a bankruptcy case who seek to protect their self interests through claim-acquisition and/or the presentation of competing plans").

(n34)Footnote 34. See, e.g., Coleman, *Purchasing Claims to Control a Vote: The Difference Between Self-Interest*

and *Ulterior Motives*, 115 *Banking L.J.* 160 (1998).

(n35)Footnote 35. 118 *F.3d* 635 (9th Cir. 1997) (finding that a secured creditor who purchased unsecured claims against the debtor, thereby successfully opposing the debtor's plan of reorganization, acted in good faith and was entitled to vote separately each such purchased claim), *cert. denied*, 522 U.S. 996, 118 S. Ct. 561, 139 L. Ed. 2d 402 (1997). See also *In re Adelphia Communications Corp.*, 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) (following *Figter* and stating that "a movant must demonstrate more than a mere selfish motive on behalf of a voting party in order for a court to designate that party's vote").

(n36)Footnote 36. *In re Figter Ltd.*, 118 *F.3d* at 639.

(n37)Footnote 37. The 1934 Act is codified at 15 U.S.C. §§ 78a-78mm. Section 12 of the 1934 Act is codified at 15 U.S.C. § 78l.

(n38)Footnote 38. See, e.g., *Crown Zellerbach Corp. v. Goldsmith*, 609 F. Supp. 187 (S.D.N.Y. 1985).

(n39)Footnote 39. See *Pin v. Texaco, Inc.*, 793 F.2d 1448, 1453-54 (5th Cir. 1986) (summarizing the tests and noting that the "Williams Act amendments do not define the term 'tender offer,' and the SEC has steadfastly refused to supply a definition, since the dynamic nature of tender offers requires administrative and judicial flexibility in determining what types of transactions should be subject to the Act and these regulations."); *Gorman v. Coogan*, 2004 U.S. Dist. LEXIS 301 (D. Me. Jan. 13, 2004) (discussing the existence of several tests and applying two different tests to the inquiry).

(n40)Footnote 40. 475 F. Supp. 783, 823-24 (S.D.N.Y. 1979), *aff'd* 682 F.2d 355 (2d Cir. 1982), *cert. denied sub nom. Dickinson v. SEC*, 460 U.S. 1069, 103 S. Ct. 1522, 75 L. Ed. 2d 946 (1983). See also P 5.12[7] *supra* for a discussion of the proxy rules of the 1934 Act. See also *Clearfield Bank & Trust Co. v. Omega Fin. Corp.*, 65 F. Supp. 2d 325, 338 (W.D. Pa. 1999) (holding that the question of whether a solicitation is a "tender offer" for section 14(d) purposes turns on whether, looking at the totality of the circumstances, it appears likely that, unless the pre-acquisition filing rules of section 14(d) are followed, there will be a substantial risk that solicitees will lack information needed to make a carefully considered appraisal of the proposal).

(n41)Footnote 41. 774 F. 2d 47 (2d Cir. 1985), *rev'd on other grounds and remanded sub nom.*, 781 F.2d 264, 1986 U.S. App. LEXIS 26714 (2D Cir.1986).

(n42)Footnote 42. *Id.* at 57; *Anago Inc. v. Tecnol Medical Products, Inc.*, 792 F.Supp. 514 (N.D.Tex. 1992), *Clearfield Bank & Trust Co. v. Omega Fin. Corp.*, n.41 *supra*, 338.

(n43)Footnote 43. *Hanson Trust PLC v. SCM Corp.*, n.- *supra*, 774 F.2d at 57. Certain courts follow yet another test laid out in *S-G Sec., Inc. v. Fuqua Inv. Co.*, 466 F. Supp. 1114 (D. Mass. 1978), where the court held that a tender offer existed where there was a publicly announced intention by the purchaser to acquire a substantial block of the stock of the target company for purposes of acquiring control thereof and a subsequent rapid acquisition by the purchaser of large blocks of stock through open market and privately negotiated purchases. See *Securities & Exch. Comm'n v. Carter Hawley Hale Stores, Inc.*, *supra* n.-, 760 F.2d at 952; *Gorman v. Coogan*, 2004 U.S. Dist. LEXIS 301, *supra* n.-, at 61.

(n44)Footnote 44. See section 14(d)-(f) of the 1934 Act (codified at 15 U.S.C. § 78n(d)(f)).

(n45)Footnote 45. Section 14(d), by its own terms, is limited to equity securities registered pursuant to section 12 of the 1934 Act (15 U.S.C. § 78l). See 15 U.S.C. § 78n(d)(1) (section 14(d)(1) of the 1934 Act).

(n46)Footnote 46. Regulation 14E is codified at 17 C.F.R. §§ 240.14e-1 through 240.14f-1.

(n47)Footnote 47. Section 10(b) of the 1934 Act is codified at 15 U.S.C. § 78j(b). Rule 10b-5 is codified at 17

C.F.R. § 240.10b-5, although §§ 240.10b-1 through 240.10b-18 should be consulted for a more complete understanding of the anti-fraud regulations promulgated under section 10(b) of the 1934 Act.

(n48)Footnote 48. At issue is whether bankruptcy claims fall under the definition of "security" for purposes of the securities laws. This question arises because an insolvency triggers a market in the troubled company's obligations, which are transformed into claims against a bankruptcy estate once a chapter 11 petition has been filed. Drain & Schwartz, n.15 *supra*, 569-70. Once a chapter 11 plan is confirmed, the debtor's obligations may translate into rights to receive securities under the plan. See *P 7.03[2][c] infra* for further discussion.

(n49)Footnote 49. Drain & Schwartz were only able to find one case, *SEC v. Texas Int'l Co.*, 498 F. Supp. 1231 (N.D. Ill. 1980), in which a federal court had applied the securities laws to regulate the trading of bankruptcy claims. Drain & Schwartz, n.15 *supra*, 615. Furthermore, *Lipper v. Texas Int'l Co.*, 1979 U.S. Dist. LEXIS 13210 (W.D. Okla. Apr. 6, 1979), was the only other case found by Drain & Swartz to even consider the issue. Drain & Schwartz, n.15 *supra*, 615. It is arguable that under the 1933 and 1934 Acts, a bankruptcy claim that could be exchanged for a post-reorganization security, is a security for the purposes of the federal securities laws. See 15 U.S.C. § 77b(a)(1); 15 U.S.C. § 78c(a)(10); Drain & Schwartz, n.15 *supra*, 610 (2002). Furthermore, in some cases a bankruptcy claim could be considered a security under the tests laid out by the Supreme Court in *SEC v. Howey Co.*, 328 U.S. 293, 66 S. Ct. 1100, 90 L. Ed. 1244 (1946) (finding that an instrument met the definition of security under the 1933 and 1934 Acts if one "invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party") and in *Reves v. Ernst & Young*, 494 U.S. 56, 110 S. Ct. 945, 108 L. Ed. 2d 47 (1990) (establishing the family resemblance test that looks to the party's motives, the plan of distribution, the investing public's reasonable expectations and the existence of another regulatory scheme to determine when an item should not be considered a security). See also Drain & Schwartz, n.15 *supra*, 617-19 (analyzing arguments for and against claims being considered securities under both *Howey* and *Reves*).

(n50)Footnote 50. See Drain & Schwartz, n.15 *supra*, 576-77 (mentioning that courts and commentators have been troubled by sophisticated buyers with superior information soliciting unsophisticated creditors who may not realize the true value of their claim).

(n51)Footnote 51. Section 4(2) of the 1933 Act is codified at 15 U.S.C. § 77d(2).

(n52)Footnote 52. Regulation D is codified at 17 C.F.R. §§ 230.501 through 230.508.

(n53)Footnote 53. See 15 U.S.C. §§ 78i-78j (anti-fraud provisions), 78n (proxies). A purchaser willing to comply with the Bankruptcy Code's solicitation and disclosure requirements may be exempt from the securities laws. See *P 7.03[2][b][iv] supra*.

(n54)Footnote 54. See, e.g., *Yell Forestry Prods., Inc. v. First State Bank of Plainview*, 853 F.2d 582 (8th Cir. 1988). Prepetition solicitations pursuant to section 1126 (in so-called "prepackaged" chapter 11 filings) must either have conformed with the applicable non-bankruptcy law, or, if there is none, the disclosure must have contained adequate information as defined in section 1125(a). See *P 6.05 supra* regarding solicitations for prepackaged chapter 11 plans.

(n55)Footnote 55. 425 U.S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976).

(n56)Footnote 56. See 7 *Collier on Bankruptcy*, P 1125.03[7] (Matthew Bender 15th Ed. Revised).

(n57)Footnote 57. While section 1125(e) as drafted applies only to "newly-organized" successors to the debtor, cases and "no-action" letters construing the provision have characterized the limitation (which is not found in section 1145, the other primary Bankruptcy Code exemption from securities laws) very liberally, going as far as to grant safe harbor protection to successors that were not "newly-organized." See, e.g., *Lezak Group, Inc.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2587 (Oct. 3, 1985).

(n58)Footnote 58. See AGS Properties et al., SEC No-Action Letter, 1991 SEC No-Act. LEXIS 1129 (Sept. 30, 1991); Richland Resources Corp., SEC No-Action Letter, 1988 SEC No-Act. LEXIS 1024 (Aug. 11, 1988); Computer Input Servs., Inc., SEC No-Action Letter, 1984 SEC No-Act. LEXIS 2165 (May 4, 1984).

(n59)Footnote 59. See *In re U.S. Truck Co.*, 11 C.B.C.2d 729, 730-731, 42 B.R. 787, 788 (Bankr. E.D. Mich. 1984) (court refused to permit transfer of claims to an affiliate of debtor before disclosure statement was approved by the court on the basis that the transfers would circumvent the disclosure requirements of section 1125 of the Bankruptcy Code), vacated, 49 B.R. 604 (E.D. Mich. 1985) .

(n60)Footnote 60. See *In re Chateaugay Corp.*, No. 86B11270 (Bankr. S.D.N.Y. Mar. 11, 1988) (court refused to approve trades of more than 400 claims to potential acquiror of debtor).

(n61)Footnote 61. See *In re Snyder*, 51 B.R. 432, 437 (Bankr. D. Utah 1985) ; *First Am. Bank of N.Y. v. Century Glove, Inc.*, 18 C.B.C.2d 777, 780, (D. Del. 1988) , modified, 860 F.2d 94 (3d Cir. 1988) . In addition, agreements to vote in favor of a plan may be permitted. See *In re Texaco, Inc.*, 18 C.B.C.2d 166, 169, 81 B.R. 806 (Bankr. S.D.N.Y. 1988) (settlement stipulation requiring Pennzoil to support Texaco plan was not "solicitation" under section 1125 because no plan was yet filed).

(n62)Footnote 62. See *In re Joe Norban, Inc.*, No. 88B-11137 (PBA) through 88B-11199 (PBA), Solicitation Statement (Bankr. S.D.N.Y. June 16, 1988).

(n63)Footnote 63. 8 *Collier on Bankruptcy*, P 1145.02[1] (Matthew Bender 15th Ed. Revised). Moreover, section 1145(c) exempts the plan securities from the resale requirements of Rule 144, promulgated under the 1933 Act. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 421 (1977), reprinted in Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). Rule 144 is codified at 17 C.F.R. § 230.144.

(n64)Footnote 64. 8 *Collier on Bankruptcy*, P 1145.03[2] (Matthew Bender 15th Ed. Revised). Section 4(1) is codified at 15 U.S.C. § 77d(1).

(n65)Footnote 65. 8 *Collier on Bankruptcy*, P 1145.03[3][a] (Matthew Bender 15th Ed. Revised). Section 2(11), defining "underwriter" for purposes of the 1933 Act, is codified at 15 U.S.C. § 77b(11).

(n66)Footnote 66. See *In re Kenilworth Sys. Corp.*, 55 B.R. 60, 62 (Bankr. E.D.N.Y. 1985) ; 8 *Collier on Bankruptcy*, P 1145.03[a] (Matthew Bender 15th Ed. Revised).

(n67)Footnote 67. This subparagraph (D) is meant to exclude from the exemption "controlling persons" of the issuer. See 8 *Collier on Bankruptcy*, P 1145.03[3][d] (Matthew Bender 15th Edition Revised). Legislative history suggests that any creditor that receives ten percent of the debtor's securities will be considered a "controlling person" and therefore will be subject to the registration requirements of section 5 of the 1933 Act (15 U.S.C. § 77e). H.R. Rep. No. 595, 95th Cong., 1st Sess. 238 (1977), reprinted in Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). This position, however, constitutes an attempt to alter the concept of "control" under the 1933 Act since nowhere in the securities laws is there a doctrine that a 10% holder is automatically a controlling person.

(n68)Footnote 68. Manville Corp., SEC No-Action Letter, 1986 SEC No-Act. LEXIS 2763 (Aug. 28, 1986); see also UNR Indus., Inc., SEC No-Action Letter, 1989 SEC No-Act. LEXIS 799 (July 11, 1989); I.C.H. Corp., SEC No-Action Letter, 1997 SEC No-Act LEXIS 528 (Apr. 14, 1997).

(n69)Footnote 69. A "1934 Act reporting company" is any issuer of securities subject to the reporting requirements of the 1934 Act.

(n70)Footnote 70. See *Richland Resources Corp. & Mid-America Resources, Inc.*, SEC No-Action Letter, 1988 SEC No-Act. LEXIS 1024 (Aug. 11, 1988); *Master Consolidated*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2017

(Apr. 5, 1985).

(n71)Footnote 71. See *In re Southland Corp.*, No. 390-37119-HCA-11 (N.D. Tex. Oct. 24, 1990) and *In re A. H. Robins Co., Inc.*, No. 85-31307-BNS (E.D. Va. Aug. 21, 1985). See also P 7.04[4][d][iii] *infra* for a discussion of the "new value" exception which allows equity holders to retain an ownership interest in a troubled company by infusing new capital into the company as part of its plan of reorganization.

(n72)Footnote 72. See P 7.05 *infra* for a discussion of asset sales pursuant to section 363 of the Bankruptcy Code.

(n73)Footnote 73. Courts have denied postpetition financings when it appears that a lender is taking advantage of its better bargaining position to the other parties' detriment. No single issue will defeat approval of a postpetition financing agreement; it is necessary to look to the entire agreement to determine fairness to the lender, to the debtor, and to the other creditors. Upon examination of the totality of the circumstances, a financing agreement may appear unduly burdensome. For example, in *In re Tenney Vill. Co.*, 104 B.R. 562 (Bankr. D.N.H. 1989), the court noted that pursuant to the DIP financing, the bank would have effectively taken over the debtor's business. All proceeds and rent from estate property would have gone directly to the bank instead of to the estate. In addition, the agreement provided that the bank would retain a veto power over confirmation of the reorganization plan. The bank was also protected from a variety of claims asserted on the estate's behalf, including preference, fraudulent transfer, lender liability, subordination and any other matter. Accordingly, the court held that the financing agreement was not supportable. But see *The Official Committee of Unsecured Creditors of New World Pasta Co.*, 322 B. R. 560, 564-65 (Bankr. M. D. Pa. 2005) (holding that a provision in the DIP financing agreement whereby the debtors may only propose a plan of reorganization and disclosure statement that have been pre-approved by the prepetition senior lenders does not violate the Bankruptcy Code). See P 9.08[6][b] *infra* for a general discussion on postpetition financings.

(n74)Footnote 74. No. 99-2933-MFW (Bankr. D. Del., Aug. 27, 1999).

(n75)Footnote 75. No. 01-00056-PJW (Bankr. D. Del. Jan. 10, 2001).

(n76)Footnote 76. See P 7.05 *infra* for a discussion of asset sales pursuant to section 363 of the Bankruptcy Code.



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Collier Business Workout Guide

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CHAPTER 7 Investing in a Troubled Company

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P 7.04 Risks of Investing in a Troubled Company.

[1] Overview.

Although presenting the opportunity for great rewards, an investment in a troubled company poses great risks to the investor. First, there are those risks that an investor will face regardless of whether the company is in bankruptcy or not; they include the risk that the investment strategy (such as obtaining a holdout position) will fail, and that the debt itself may carry unexpected liabilities for the holder.ⁿ¹ Second, a troubled company that files to reorganize under chapter 11 of the Bankruptcy Code poses other complications for the investor. The chapter 11 filing fundamentally changes the relationship between the investor and the troubled company, and the investor must plan ahead to prepare for these changes.

[2] Risks in a Workout.

An investor in a troubled company, even before bankruptcy, faces risks greater than those associated with more routine investments. The primary risk, of course, is that the company, despite the investor's hopeful projections, will not dig its way out of its problems. The workout may not succeed; and even if it does, an unexpected delay may cause the value of the investment to deteriorate. Moreover, if the investor acquires the company's equity, a restructuring that depends on the issuance of additional equity to debtholders will, most likely, dilute the investor's interest.

An investor who obtains a blocking position in an out-of-court workout for the purpose of gaining control also faces the possibility that it may not succeed in securing the expected benefit of its position. Out-of-court restructurings take many forms and debtors can at times work around the recalcitrant investor. For example, if the position held by the investor is not subject to contractual minima (such as may be found in an indenture that requires a certain percentage for amendment), the leverage may evaporate if the company reduces the minimum votes required to accept the plan.ⁿ²

There are other possible risks in capitalizing on a blocking position. Amounts received in excess of what other similarly-situated creditors receive may be characterized as preferences under state or federal bankruptcy laws, and consequently may be voidable by other creditors or the trustee in bankruptcy.ⁿ³ In addition, the holdout creditor may face castigation by accepting creditors, especially if a workout plan was close to acceptance, which may affect the reputation of the holdout creditor, especially if it is a participant in workout negotiations.

In relation to this particular risk, the timing of the acquisition of claims for the purpose of blocking a workout may

prove to be vital. For instance, acquiring a bank claim for such purpose when a workout agreement has already been approved by the steering committee (or was close to approval) may even subject the holdout creditor to a claim for tortious interference with contract based on its disruption of the workout plan. The court in *In re Ashby Enterprises, Ltd.*,ⁿ⁴ in which one holdout creditor refused to agree to the composition already accepted by more than two-thirds of creditors, found no tortious interference. However, the holdout creditor in *Ashby* was one of the original creditors of the debtor and was itself in the process of liquidation and so hardly in the position to write off one of its large accounts receivable. The court emphasized that one of the essential elements of the cause of action of tortious interference was lack of good faith in asserting an interest.ⁿ⁵ Thus, the result may well be different when the holdout creditor is an investor whose legally-protected interest may seem to have been created specifically for the purpose of interfering with the contractual relationships between the debtor and its original creditors. Incidentally, the selling creditor may also be liable if it is proven that it knew at the time of the sale for what purpose its claim was purchased.

[3] Risks Related to Certain Liabilities.

[a] In General.

A lender always has an interest in the assets and business of the debtor, both to provide comfort that the debt payments will be made, and, if they are not, that the debtor has sufficient assets to satisfy the lender's lien or judgment. Consequently, prudent investors make loans only after conducting extensive due diligence and receiving representations and warranties (supported by indemnities where possible) from the debtor as to its financial condition, the validity of the securities being sold and other matters.ⁿ⁶

For an investor in a troubled company, the ability to obtain these types of assurances minimizes the risk to the realization of the return on its investment. However, the investor who buys claims from creditors cannot usually receive comfort in these matters from the company, but must instead decide whether there is a possibility to receive any representations from the seller of the claims or whether certain risks would simply make the investment inadvisable.

A debt or equity investor in a troubled company acquires the benefits of the security it purchases, but is also subject to any defenses available to the obligor.ⁿ⁷ An investor should be careful to protect itself against unexpected loss through due diligence, representations and indemnification from the seller. These representations should include, at a minimum, representations as to ownership and validity of the claim and any supporting security interest. The purchaser should also seek to be indemnified against possible lender liability and environmental and fraudulent conveyance claims.

It will not always be possible to obtain these indemnifications. However, the willingness to bypass them will provide an edge over other bidders. In *In re Apex Oil Co.*,ⁿ⁸ the willingness to purchase claims without representations and warranties from the seller helped a buying group with ties to the debtor prevail over a bidder unwilling to take such risks. The buying group, which included, with a 49.9% interest, the chief operating officer of the debtor, agreed to purchase bank claims at a discount; separately, it agreed with the debtor to purchase certain of its assets in satisfaction of such claims. The buying group agreed to take the claims without representations and warranties, or indemnities from the banks as to the validity and enforceability of the claims and the related liens on the assets. However, the deal was subject to the banks' receiving releases from the debtor covering possible lender liability claims.

A second bidder for the debtor's assets, Getty Petroleum Corp. ("Getty"), challenged the agreements in bankruptcy court, arguing that the buying group was favored to Getty's disadvantage because of its close relationship to the debtor's management. Getty claimed that since it was unwilling to take the claims without the representations and warranties and indemnities from the banks, at least not at the same discounted price offered by the buying group, and was unable to compel the debtor to release the banks from the lender liability claims, it was unable to purchase the claims (and thus the assets) at a price and on the terms the banks would accept. The court rejected Getty's arguments, citing other reasons (such as Getty's prior failure to consummate an agreed-upon sale) for the rejection of Getty's bid, and discounted the value of the management's role in the acquisition by the buying group. The case illustrates the difficulties befalling a

buyer insisting on customary protections relating to the debt of a troubled company, as well as the opportunities available to management groups in such sales.

[b] Environmental Matters.

Compliance with federal, state and local environmental laws, like those regulating pollutant discharges into the air, water and land, can require significant expenditures by companies. Some laws, such as the Comprehensive Environmental Response, Compensation and Liability Act ("CERCLA"),ⁿ⁹ can impose vast liabilities on a company that has arranged for disposal of hazardous waste or that owns or operates property upon which or from which hazardous materials have been released. Liabilities may be imposed even if environmental damages were caused entirely by a prior owner or operator and may arise from disposal occurring either on-site or distant from the company's property.^{n9.1}

The financial impact of environmental laws may be acutely felt by an already troubled company to the detriment of its investors.ⁿ¹⁰ Liabilities and obligations, including capital expenditures necessary to bring a facility into compliance with environmental laws, remediation costs, and civil and criminal fines can directly impair the ability of the company to make its debt payments. In addition, the presence of hazardous substances on property can diminish the value of the investors' collateral. Environmental costs may be particularly significant for investors in the bankruptcy setting: for instance, bankruptcy may not be a reliable way to stay government actions concerning environmental cleanup, and cleanup costs may have administrative expense priority over other debts in bankruptcy.ⁿ¹¹

Environmental laws may directly affect investors in other ways. For instance, CERCLA and a number of state statutes impose liens on property for government cleanup costs, which may affect the value and marketability of the company. Although many state environmental liens do not take priority over prior recorded liens, a number of state "superlien" statutes place the environmental lien above all or most prior liens.ⁿ¹² Satisfaction of "superliens" can leave a troubled company without sufficient assets to make debt payments to even its senior debt holders.

Investors may also become liable for the environmental costs of the company. An investor may be liable for cleanup under CERCLA if it manages or directs the affairs of a company's polluting facility. Thus, an investor should not involve itself in the affairs of the company beyond the extent necessary to protect its investment, especially in regard to management decisions which may contribute to contamination.ⁿ¹³

If the investment vehicle is debt securities, the investor may find itself in a position closely analogous to that of the debtor's lender, and may have to grapple with decisions such as whether to foreclose on the property securing the debt obligations. Should the investor foreclose upon contaminated property to ensure performance of the debt obligation, the investor should preserve the assets of the facility and consider transferring the property at the earliest practicable time on commercially reasonable terms.ⁿ¹⁴

Pre-investment due diligence should evaluate the company's compliance with environmental laws and potential cleanup obligations and should consider matters that may subject the company (and possibly the investor) to liability. In this regard, it is often necessary for an environmental consultant or engineer to carry out an environmental site assessment prior to the investment. The extent of such an investigation varies depending upon the nature of the company and the condition of the collateral. An environmental site assessment often includes a site inspection, interviews of company employees, reviews of environmental records maintained by the company and government bodies, and reviews of aerial photographs. A site assessment should also evaluate the company's environmental compliance history and prior uses of the property. Depending on the findings of the investigation, the review may be supplemented with a subsurface investigation or other on-site testing.

[c] Investments in a Leveraged Company.

Acquisition of a debt security initially issued in connection with a leveraged buyout may create significant risks to the purchaser.ⁿ¹⁵ Many LBOs carry with them some degree of fraudulent conveyance risk, based on the claims from existing creditors or the trustee in bankruptcy that the increase in leverage from the LBO fraudulently enriched the selling shareholders or the LBO lender at their expense. Under federal bankruptcy lawsⁿ¹⁶ and state fraudulent conveyance laws,ⁿ¹⁷ a fraudulent conveyance generally will be found if the company received less than fair value in return for the incurrence of the debt and the company was insolvent on the date of such incurrence, or was made insolvent as a result of it; the remaining property provides the company with unreasonably small capital to carry out its business; it is proved that the company intended to incur debts beyond its ability to pay as they matured; or the company incurred debts to or for the benefit of an insider, under an employment contract and not in the ordinary course of business.ⁿ¹⁸

The LBO debt, therefore, may be voidable in the hands of any postbankruptcy investor unless that investor can establish both that it is a holder in due course and that a holder in due course is not subject to a fraudulent conveyance attack.ⁿ¹⁹ As a practical matter, however, as commentators have pointed out,ⁿ²⁰ LBO debt may be even more voidable in the hands of a postbankruptcy investor; by accumulating claims, the investor makes itself a much easier target than numerous prepetition holders. If a fraudulent conveyance is found, a creditor or the debtor may be able to subordinate the debt obligations subject to the claim and annul any security interests obtained in connection therewith.

An acquiror of LBO debt assumes these risks when it purchases the securities. Accordingly, the new investor should request an indemnity from the seller covering these risks. In addition, the investor should try to obtain an assignment of the transferor's indemnity rights against the company. Since the holders of LBO debt may also have securities laws claims against the company based on inaccuracies or misstatements in the offering materials, the acquiror should also attempt to obtain a transfer of rights to these claims as well.ⁿ²¹

[4] Risks in a Chapter 11 Case.

[a] In General.

An investor in a troubled company faces additional problems to those described above if the company files a petition to reorganize under chapter 11. First, upon the filing of the bankruptcy petition, an automatic stay is imposed which prohibits substantially all actions against the debtor and limits the opportunity for investors to gain appropriate relief for breaches by the debtor. Second, chapter 11 rules give management more power over creditors than it would otherwise have outside of bankruptcy. Third, an investor runs the risk that a plan unfavorable to its investment will be confirmed by the bankruptcy court over its objections. Fourth, certain types of claims are subject to special rules under the Bankruptcy Code that may affect their value in the plan.ⁿ²²

[b] Automatic Stay and Payment of Interest.

Upon the filing of a petition to reorganize under chapter 11, *section 362 of the Bankruptcy Code* imposes an automatic injunction prohibiting most actions against the debtor, including actions to recover outstanding debts or to enforce liens.ⁿ²³ This section serves the Bankruptcy Code's policies of allowing the debtor time to fashion a reorganization of its business without pressure from creditors, and, by preventing creditors from racing to enforce their rights against the debtor, of providing for equal treatment of creditors of the same class in the plan of reorganization. A creditor able to show that its interest in the debtor's property will not be adequately protected in the bankruptcy case can petition the court to grant relief from the stay.ⁿ²⁴ "Adequate protection" generally requires that a lien holder be protected against a decrease in the value of its security resulting from the debtor's continued use of the collateral.ⁿ²⁵

A creditor unable to benefit from the adequate protection exception may find its debt payments suspended. The filing of the bankruptcy petition will, in many cases, give the debtor relief from the payment of interest on its debt. Section 502(b)(2) excludes claims for "unmatured interest," and thus prohibits payment of postpetition interest on debt by the

debtor. However, *section 506(b) of the Bankruptcy Code* requires the payment of interest to oversecured creditors. This is generally construed to be at the contract rate.ⁿ²⁶ In addition, cases under the Bankruptcy Code allow creditors to collect postpetition interest from solvent debtors.ⁿ²⁷

[c] Control of Management.

Any bargaining leverage that an investor may have over the troubled company in a workout or otherwise may be significantly lessened once the company files for chapter 11. *Section 1121 of the Bankruptcy Code* gives the debtor a 120-day exclusive period to file a plan of reorganization.ⁿ²⁸ Historically, courts have granted frequent extensions sometimes cumulating several years in length. But under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the court may terminate a debtor's exclusivity period to file a plan and solicit acceptances thereof, and may not grant extensions of (i) more than 18 months after the date of the order for relief for the exclusive right to file a plan, or (ii) more than 20 months after the date of the order for relief for obtaining acceptances.ⁿ²⁹

Consequently, an investor whose investment is dependent on the value of securities issued under the plan, or a potential acquiror of these securities, must depend on the debtor's and its management's approval of plan terms beneficial to it, or wait for the debtor's exclusivity period to run out. When added to the risk that management might be able to capitalize on its position--such as in *Apex Oil*, in which management allegedly facilitated a sale of assets to an affiliated buying group by agreeing to release lenders from possible lender liability claimsⁿ³⁰--the likelihood that a hostile transaction would succeed has historically diminished. However, the effects of the 2005 amendments to the Bankruptcy Code on a debtor's control over its reorganization process have yet to be seen. The limitation on extensions to the debtor's exclusive filing period enacted under the 2005 Act may increase an investor's bargaining power and its ability to effectuate a hostile transaction once exclusivity has expired.

Moreover, of practical importance to any investment, the Bankruptcy Code permits the debtor and its management to continue running the company.ⁿ³¹ Although *section 1104 of the Bankruptcy Code* allows appointment of a trustee "for cause ...; if such appointment is in the interest of creditors, any equity security holders, and other interests of the estate; or if grounds exist to convert or dismiss the case under section 1112," the legislative history of this section clearly demonstrates that Congress focused primarily on fraud, dishonesty, incompetence or gross mismanagement as justifications for appointing a trustee.ⁿ³² Essentially, Congress determined that displacing management would be so detrimental to the preservation of the estate and to the reorganization process as a whole that only a showing of wrongful conduct or gross negligence could justify it. The courts have generally followed this congressional determination,ⁿ³³ although the lesser "interest of creditors" standard has been used in certain cases.ⁿ³⁴ Pursuant to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, section 1104(a) now gives the court leave to appoint a trustee in cases that may be converted or dismissed pursuant to Section 1112, in those cases where the court determines that the appointment of a trustee is in the best interests of creditors and the estate.ⁿ³⁵ Pursuant to the Act, the U.S. Trustee is also required to seek appointment of a trustee under section 1104(a) if there are "reasonable grounds" to suspect that the debtor's governing body, chief executive or chief financial officer, or the governing body that selected such officers "participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting."ⁿ³⁶ Notwithstanding the additional grounds for appointment of a trustee, the legislative history of the 2005 Act, while silent on the addition of subsection 1104(e), clearly states that the amendment of section 1104(a) "is not intended to ease the standards for appointing chapter 11 trustees."ⁿ³⁷

In certain specified cases, when the appointment of a trustee is not warranted, the court may appoint an examiner to investigate the actions of the debtor's management. But, just as with the appointment of a trustee, the courts have historically been reluctant to do so absent clear evidence of dishonesty or gross negligence.ⁿ³⁸ In most cases, therefore, the existing management will remain in control and, sheltered from some of the pressures for their removal that they may feel outside of bankruptcy, may continue to carry out those practices that many investors may believe led to the company's misfortunes in the first place. While certain of the management's actions are subject to considerable scrutiny by the bankruptcy court,ⁿ³⁹ the business judgment standard does not change because of the company's bankruptcy.ⁿ⁴⁰

[d] Risk of Non-Impairment and Cramdown.

Subsection (c) of *section 1126 of the Bankruptcy Code* provides that a plan of reorganization must be approved by a vote of creditors holding two-thirds in amount and more than one-half in number of the allowed claims voting in that class.ⁿ⁴¹ Pursuant to subsection (d) of section 1126, acceptance of a plan by a class of interests requires acceptance by the holders of two-thirds in amount of such interests voting in that class.ⁿ⁴² Thus, an investor may attempt to gain leverage in negotiating with the debtor by purchasing enough securities to block any plan of reorganization.ⁿ⁴³

An investor planning to use this tactic, however, faces the risk that the debtor will be able to adopt a plan of reorganization notwithstanding the investor's opposition. First, if the plan does not "impair" the investor's class, it may be confirmed over the investor's objections. Second, a plan may be confirmed by a bankruptcy court over an impaired, objecting class under the "cramdown" process of *section 1129 of the Bankruptcy Code*.

[i] Non-Impairment.

Section 1126(f) provides that a class that is not "impaired" under a plan is conclusively presumed to have accepted the plan, thereby denying investors in that class the opportunity to object to the plan.ⁿ⁴⁴ A claim is not impaired if the plan (i) leaves unaltered the legal and contractual rights to which the claim holder was entitled under its claim or (ii) cures any defaults in connection with the claim and compensates the holder for such defaults.ⁿ⁴⁵ While most investors may be satisfied with a plan so long as their claim is "unimpaired," this definition may result in a confirmed plan unfavorable to some investors, particularly those who believe their claim was undervalued for purposes of allowance under the plan and thus the cash amount received under the plan was lower than they expected.ⁿ⁴⁶

[ii] Cramdown.

A plan may also be confirmed by a bankruptcy court over an investor's objections through the "cramdown" process. *Section 1129 of the Bankruptcy Code* requires that each impaired class accept the plan before it is confirmed, unless the plan "does not discriminate unfairly" and is "fair and equitable" with respect to that class.ⁿ⁴⁷

While the Bankruptcy Code does not define "unfair discrimination," the legislative history provides an explanation of what this concept means.ⁿ⁴⁸ Briefly stated, "unfair discrimination" of a class of claims results when a class is treated differently, with respect to allocation of value, from other classes "of equal rank." The problem with this test, of course, is the difficulty often involved in determining whether a particular class of claims is of equal, junior or senior rank as compared to other classes. For example, from the perspective of a holder of unsecured trade claims, claims of senior and subordinated debentures are of the same rank. However, from the perspective of the holders of senior debentures, the subordinated debentures are junior. Thus, "unfair discrimination," which, if proved, could save a particular class from the "cramdown," may not be readily provable.

Section 1129(b)(2) of the Bankruptcy Code provides that a plan is "fair and equitable" with respect to a class of secured claims, and thus may be approved over their objections, if (i) the holders of the claims retain the liens securing the claims to the extent of the allowed amount of the claims, and receive deferred cash payments in an amount, as of the effective date of the plan, equaling at least "the value of such holder's interest in the estate's interest in such property"; (ii) the property subject to the creditor's liens is sold free and clear of such liens, such liens attach to the proceeds of the sale, and the liens on the proceeds are treated the same as under (i) or (iii); or (iii) the holder receives the "indubitable equivalent" of its claims.ⁿ⁴⁹ The "indubitable equivalence" between the proposed distribution and the original claim is determined on a case-by-case basis. Abandonment of the collateral to the creditor or strict cash equivalence would always satisfy the test. The courts and commentators disagree, however, as to whether, and under what circumstances, securities (other than the newly issued equity securities in the reorganized debtor, which are expressly excluded) may constitute the requisite "indubitable equivalent."ⁿ⁵⁰

Section 1129(b) provides that a plan may be "crammed down" over objections of a class of unsecured claims if (i) the plan provides that the holder receive or retain property of a value, as of the effective date of the plan, equal to the allowed amount of its claim, or (ii) no claim junior to such class receives or retains any property under the plan on account of such junior claim. This is referred to as the absolute priority rule.ⁿ⁵¹

Finally, the section provides that the plan may be "crammed down" over objections of equity holders if (i) the plan provides that such holders receive or retain property having a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which the holder is entitled, or the value of its interest, or (ii) no junior holder will receive or retain any property under the plan on account of such junior interest.ⁿ⁵²

For the investor in a troubled company, the "cramdown" process means that it will lose a measure of leverage over the reorganization process. In particular, unsecured creditors and equity holders run the risk that they will not receive or retain a significant portion of their investment at all, a permissible result as long as no holders junior to their class receive or retain any property under the plan on account of such junior interest. Some investors, however, may favor a "cramdown" if, as a result, they receive a controlling share of equity securities in the debtor that may be moved from a more junior class into their class in order to effect the cramdown.

The voting procedures in the Bankruptcy Code, by emphasizing the classification of claims,ⁿ⁵³ make the selection of the type of investment of extreme importance. *Section 1122 of the Code* provides that a claim will be classified with others "substantially similar" to it. Given that the debtor, during the 120-day exclusivity period, controls the development of the plan and thus the classification of the claims, an investor cannot predict with certainty the placement of its claim.ⁿ⁵⁴ As a result, an investor runs the risk that its claim will be placed in a class vulnerable to "non-impairment" or "cramdown." The plan may place the claim or interest in a class that gives the investor an unacceptably low return on its initial investment.

[iii] "New Value" Exception.

Equity holders may retain an ownership interest in a troubled company, over the objection of an impaired class of unsecured creditors, by infusing new capital into the company as part of its plan of reorganization.ⁿ⁵⁵ This is called the "new value" exception (or corollary) to the absolute priority rule. While the Bankruptcy Code codified the absolute priority rule, it remained silent with respect to the new value exception. As a result of this legislative silence, there has been a debate among courts as to whether the new value exception survived the codification of the absolute priority rule.ⁿ⁵⁶

Beyond statutory interpretation arguments, the debate turns upon the perceived fairness or unfairness of the new value exception. On the one hand, some point to the benefits of the new value exception for troubled companies in particular and the economy in general.ⁿ⁵⁷ For example, the controlling shareholder of a troubled company or the sponsor of a leveraged buy-out company that has failed may wish to participate in the profits that such company, once reorganized, may generate in the future. By allowing such shareholder or sponsor to infuse new capital into their company pursuant to what is known as a "new value" plan, advocates of the new value exception believe that more troubled companies will be able to reorganize successfully. On the other hand, opponents stress that any such benefits are outweighed by the risk that existing equity holders will take advantage of their control of an insolvent company to impose a plan of reorganization that unfairly deprives creditors of property that they own economically (if not yet legally).ⁿ⁵⁸

In light of these diverging concerns, most courts that have recognized the continued existence of the new value exception under the Bankruptcy Code have required that existing equity holders' contribution of new capital be: (1) new, (2) substantial, (3) money or money's worth, (4) necessary for a successful reorganization, and (5) reasonably equivalent to the value of the property that such existing equity holders are to retain or receive under the plan.ⁿ⁵⁹

Against this background, in *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership* (*In re 203 North LaSalle Street Partnership*),ⁿ⁶⁰ the Supreme Court examined the conditions under which existing equity holders may infuse new capital into a troubled company as part of its plan of reorganization.

The debtor in *LaSalle* was a limited partnership that owned a single real estate asset on which Bank of America National Trust and Savings Association ("Bank of America") held a lien securing its \$93 million loan. The debtor's principal reason to reorganize was to avoid the significant tax liability that would result from foreclosure by Bank of America. The plan of reorganization, which was filed within the debtor's 120-day exclusivity period, provided that the debtor's partners would contribute \$6.125 million in new capital over the course of five years in exchange for a 100% ownership of the reorganized debtor and that Bank of America's claim would be divided into a secured portion and an unsecured portion (with the latter to be classified separately from the debtor's other general unsecured claims). Since the debtor's partners would retain an ownership interest in the reorganized debtor even though Bank of America's unsecured claim would not be paid in full, Bank of America objected on the basis that the plan did not meet the fair and equitable requirement under *section 1129(b)(2) of the Bankruptcy Code*.ⁿ⁶¹ The bankruptcy court confirmed the plan based on the new value exception to the absolute priority rule. The bankruptcy court's decision was affirmed by both the district court and the Court of Appeals for the Seventh Circuit, and reversed by the Supreme Court.

The Supreme Court declined to decide whether the Bankruptcy Code included a new value exception to the absolute priority rule. Rather, it focused on the question of whether the debtor's plan violated the absolute priority rule by allowing the debtor's partners, as junior claimants, to receive an ownership interest in the reorganized debtor "on account of" their existing ownership interests in the debtor. The Court concluded that the debtor's plan violated the absolute priority rule because it did not extend "an opportunity to anyone else either to compete for [the debtor's] ... equity or to propose a competing reorganization plan."ⁿ⁶² The debtor's exclusive statutory opportunity to file a plan, which, once accepted, would prevent anyone else from obtaining equity interests in the reorganized debtor, was clearly something of value for the debtor's partners. The exclusive character of such opportunity, thereby protecting the opportunity from market scrutiny, and the fact that it was obtained at no cost led the Court to conclude that such opportunity was obtained "on account of" the partners' existing equity interests in the debtor. As a result, the debtor's plan violated the absolute priority rule and could not be confirmed over Bank of America's objection.

As commentators have noted, *LaSalle* does not settle the new value debate, nor does it prohibit new value plans.ⁿ⁶³ While the Supreme Court did not positively define the attributes of a permissible new value plan, the decision clearly stated that "plans providing junior interest holders with exclusive opportunities free from competition and without benefit of market valuation" are not permissible.ⁿ⁶⁴ The implication is that exposure to the market would show whether existing equity holders paid a fair price for the right to retain an ownership interest in the reorganized company.

The lack of clear guidelines from the Supreme Court in *LaSalle* will make it more difficult for equity holders to rely on the cramdown provisions under the Bankruptcy Code and impose a new value plan on a dissenting impaired class of unsecured creditors, without subjecting such plan to a market test. What constitutes sufficient "competition" and "market valuation" in this context is unresolved. For example, would allowing competing plans to be filed or holding a form of an auction for the debtor's cramdown plan suffice? Must the debtor's exclusive right to propose a plan be terminated to allow competing plans to be filed? What happens if no competing plan is filed? What form should the auction take, when should it be conducted, who should supervise, who should be solicited and who would be qualified to bid?

Cases following *LaSalle* have provided some answers to these questions. A Third Circuit case interpreting *LaSalle* held that the prohibition on exclusivity was not violated by the majority shareholder securing the release of some liabilities, when a creditor was allowed to make offers (that were rejected) for such liabilities before they were extinguished.ⁿ⁶⁵ However, some post-*LaSalle* cases have arguably made *LaSalle's* impact even less clear. As one commentator pointed out, in the few cases decided after *LaSalle*, courts have generally not imposed auctions or other forms of market test to new value plans.ⁿ⁶⁶ For example, one post-*LaSalle* court, when faced with competing plans, simply selected one of the plans itself rather than letting the market decide.ⁿ⁶⁷

At minimum, *LaSalle* has been relied on for the proposition that equity holders do not have an exclusive right to invest in the debtor as part of the plan process,ⁿ⁶⁸ but it is still not yet clear what that means in practice.

[e] Risks of Particular Claims.

The Bankruptcy Code follows the general rule discussed above that in most cases the rights and liabilities of the original debtholder or shareholder will follow the transfer of the claim or share.ⁿ⁶⁹ Thus, debt issued in connection with a leveraged buyout made within two years of the filing of the bankruptcy petition that is deemed to be a fraudulent conveyance may be voidable in the hands of the new investor as well as the initial holder.ⁿ⁷⁰ In addition, any bankruptcy defenses based on the debt, such as a voidable preference claim under *section 547 of the Bankruptcy Code*, may be applied against the existing holder. Finally, the actions of a previous holder may be used to subordinate the transferred debt against other claims.ⁿ⁷¹

The converse rule is that the benefits of a claim will also follow the transfer. Consequently, an investor holding debt acquired at a discount may enforce the debt at par.ⁿ⁷² The Second Circuit reversed a decision of the bankruptcy court for the Southern District of New York that had established a significant exception to this rule.ⁿ⁷³ The bankruptcy court had determined that the amount by which the face value of a new debt security issued in an exchange offer exceeds the fair market value at the time of exchange of the old debt security surrendered constitutes original issue discount and, to the extent unamortized as of the petition date, is considered unmaturing interest and not allowable as a claim in bankruptcy.ⁿ⁷⁴

The effect of the bankruptcy court's ruling has been substantially mitigated, but not eliminated. The Second Circuit limited its reversing opinion to the case of an exchange of like face amounts of debt securities, and distinguished and did not rule upon an exchange that results in a net reduction of outstanding debt or an exchange of outstanding equity securities for newly issued debt securities.

In addition, certain claims themselves are subject to special rules in the Bankruptcy Code. For instance, the amount of a claim resulting from the termination of a real property lease will be limited to the amount due under the lease prior to the earlier of the filing of the bankruptcy petition and the repossession of the leasehold, plus one year's amount of rent, or, if greater, the rent for 15% of the remaining lease term, not to exceed three years.ⁿ⁷⁵ The amount of claims resulting from the termination of an employment contract is limited to the amount due under the contract on the earlier of the date of filing of the bankruptcy petition and the termination of the contract, plus one year's compensation.ⁿ⁷⁶

[f] Disclosure Requirements for Committee Members

In many cases, once a company has entered bankruptcy, an investor may have to consider whether to accept an appointment by the United States trustee to an Official Committee, or join an ad hoc committee, of creditors or equity security holders.ⁿ⁷⁷ The advantages of committee membership include increased negotiating power and authority in protecting and advancing the rights of a particular tier in the company's capital structure, being recognized by the court to appear in the bankruptcy case, combining strategies with other similarly situated holders and sharing advisory and legal fees. These benefits need to be weighed against certain obligations and risks that may come with committee membership, such as the duty to provide access to information to holders not on the committee, restrictions on the members' ability to trade the debtor's securities and the possibility of public disclosure of the investor's identity as well as the timing and amounts of its acquisitions of the debtor's securities.

Under the recently-enacted provisions of *Section 1102(b)(3)(A) of the Bankruptcy Code*, members of an official committee have duties to share information with other creditors of claims of a kind represented by the committee.ⁿ⁷⁸ The official committee of creditors in *In re Refco, Inc.*, concerned about how to comply with the new provision's disclosure requirements while protecting confidential and privileged information, filed a motion for approval of a

protocol to comply with the new requirements.ⁿ⁷⁹ The court approved a protocol whereby nonprotected information would be posted on a website that all creditors could access, and parties could gain access to protected information by agreeing to confidentiality and trading restrictions.

As well, committee members, who have access to material non-public information, may be restricted from trading in the debtor's securities. Often, debtors will petition the court for a trading order outlining the provisions pursuant to which committee members may trade. Investors will often need to employ safeguards such as screening walls to separate the information available to committee members from the investor's trading operations.ⁿ⁸⁰

Members of ad hoc committees also face the risk that in some jurisdictions the members may be required to disclose their identities and the pricing information regarding their acquisition of their securities pursuant to *Bankruptcy Rule 2019(a)*. This rule requires disclosure of the amounts of claims and interests owned by members of the ad hoc committee, the times acquired, the amounts paid therefor, and any sales or other disposition thereof.ⁿ⁸¹ This rule received scant attention until the Southern District of New York held in *In re Northwest Airlines Corp.* ⁿ⁸² that a law firm's filing of a *Rule 2019* statement naming itself as the representative of an ad hoc committee of equityholders was insufficient to comply with the rule and ordered the individual members of the committee to comply with the rule's disclosure requirements. This led to an outcry in the hedge fund community.

This decision was not followed by the Southern District of Texas. In *In re Scotia Development LLC*, the judge held that an ad hoc committee of bondholders was not a committee but a "bunch of creditors" represented by a single law firm.ⁿ⁸³ Until this split in decisions is resolved, a debt or equity holder on an ad hoc committee should be on notice that its holdings and trading information with respect to the debtor's securities may be subject to disclosure in certain jurisdictions. Investors who want to safeguard this information may need to hire their own advisors and avoid joining a committee.

FOOTNOTES:

(n1)Footnote 1. See, e.g., P 7.04[2], [3][b], [c] *infra*.

(n2)Footnote 2. Such course of action, however, will not be risk free for the company either: the creditors who have earlier agreed to the workout will now be free to change their votes, and the success of the workout may be jeopardized. See, e.g., *Texas Belting & Mill Supply Co. v. C. R. Daniels, Inc.*, 401 S.W.2d 157, 159 (Tex. Civ. App. 1966) .

(n3)Footnote 3. See *White v. Kuntz*, 107 N.Y. 518, 525, 14 N.E. 423, 426 (1887) (composite agreement void where one creditor received secret premium cash payment). See also *Hanover Nat'l Bank v. Blake*, 142 N.Y. 404 (1894) (secret agreement granting additional security to one creditor deemed void and unenforceable.)

(n4)Footnote 4. 47 B.R. 394 (D.D.C. 1985)

(n5)Footnote 5. 47 B.R. 394, 397 .

(n6)Footnote 6. In addition to those set forth in the text, customary representations and warranties include representations as to the corporate status of the issuer, the issuance of the securities not being in conflict with other agreements of the issuer, title to assets, status of leases and other material contracts, environmental matters and taxes.

(n7)Footnote 7. The only exception to this rule is the defense and right of setoff, which exists only when the debtor and creditor hold mutual claims. See 11 U.S.C. § 553(a).

(n8)Footnote 8. 92 B.R. 847 (Bankr. E.D. Mo. 1988) .

(n9)Footnote 9. 42 U.S.C. §§ 9601-9675.

(n10)Footnote 9.1. The traditional common law rule on successor liability holds that a purchaser of assets does not succeed to the seller's liabilities except the below four circumstances: (1) "the successor expressly or impliedly agrees to assume them"; (2) "the transaction may be viewed as a de facto merger or consolidation"; (3) "the successor is the 'mere continuation' of the predecessor"; or (4) "the transaction is fraudulent." See *Philadelphia Elec. Co. v. Hercules, Inc.*, 762 F.2d 303, 308-309 (3d Cir. 1985) ; *State of New York v. Nat'l Servs. Indus., Inc.*, 352 F.3d 682, 687 (2d Cir. 2003) . Some circuits have used an 8-factor test to determine if the purchaser is a "substantial continuation" of the seller in CERCLA cases. (see *United States v. Carolina Transformer Co.*, 978 F.2d 832, 838 (4th Cir. 1992) ; *United States v. Mexico Feed and Seed Co., Inc.*, 980 F.2d 478, 487-88 (8th Cir. 1992)) . However, the Supreme Court's decision in *United States v. Bestfoods*, 524 U.S. 51, 118 S. Ct. 1876, 141 L. Ed. 2d 43 (1998) , rejected the expansion of the already existing rules of corporate liability under CERCLA, which calls the substantial continuity test into question. 524 U.S. 51, 118 S. Ct. 1876, 141 L. Ed. 2d 43 (1998) . See also *Action Manufacturing Co., Inc. v. Simon Wrecking Co.*, 387 F. Supp. 2d 439 (E.D. Pa. 2005) (discussing the various circuits split on the application of the substantial continuity test and holding that the substantial continuity test is not part of the federal common law and should be rejected in the interests of a national uniform rule on successor liability.)

(n11)Footnote 10. In addition to successor liabilities as discussed in n.10 *supra.*, a parent corporation could be liable for the actions of its subsidiary under CERCLA if the common law rules for piercing the corporate veil were met. See *United States v. Bestfoods*, n. 9 *supra.*, 524 U.S. at 62 (discussing circumstances under which a parent company may be liable under CERCLA for the actions of a subsidiary); *U.S. v. Friedland*, 173 F. Supp. 2d 1077 (D. Colo. 2001) (holding that if a parent corporation remains sufficiently independent from a subsidiary, it will not be held liable under CERCLA for actions of the subsidiary); *Schiavone v. Pearce*, 77 F. Supp. 2d 284 (D. Conn. 1999) (holding parent not directly liable for clean-up costs under CERCLA absent evidence that parent acted inconsistently with typical parent/subsidiary relationship).

(n12)Footnote 11. See P 4.03[3][c] *supra.*

(n13)Footnote 12. See, e.g., *Conn. Gen. Stat. § 22a-452a*; *Me. Rev. Stat. Ann. tit. 38, § 1371*; *Mass. Gen. Laws ch. 21E, § 13*; *N.J. Stat. Ann. § 58:10-23.11(f)*.

(n14)Footnote 13. For a discussion of shareholder liability under CERCLA, see *United States v. Bestfoods*, *supra.* n.10, 524 U.S. at 61-65 ; see also *Geraghty & Miller, Inc. v. Conoco Inc.*, 234 F.3d 917, 928 (5th Cir. 2000) .

(n15)Footnote 14. See 42 U.S.C. 9601(20)(E)(ii) ("The term 'owner or operator' does not include a person that is a lender that did not participate in management of a vessel or facility prior to foreclosure ... if the person seeks to sell, re-lease (in the case of a lease finance transaction), or otherwise divest the person of the vessel or facility at the earliest practicable ... time, on commercially reasonable terms, taking into account market conditions and legal and regulatory requirements.").

(n16)Footnote 15. For a discussion of leveraged buyouts in the context of fraudulent transfers, see Cook, Ranney-Marinelli and Marafioti, *Fraudulent Transfers*, 876 PLI/Comm 511 (2005).

(n17)Footnote 16. The Bankruptcy Code's fraudulent conveyance provisions are contained in section 548.

(n18)Footnote 17. State fraudulent conveyance laws generally follow either the Uniform Fraudulent Conveyance Act, 7A U.L.A. 67 (West 1999) ("UFCA"), or its successor, the Uniform Fraudulent Transfer Act, 7A U.L.A. 301 (1999) ("UFTA"). Both are similar, but not identical, to section 548 of the *Bankruptcy Code*.

(n19)Footnote 18. See 11 U.S.C. § 548(a)(1)(B), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005; UFCA §§ 4 and 6; and UFTA § 4(a)(2). See generally P 4.06 *supra.*

(n20)Footnote 19. An acquiror of claims may be liable to the estate as a transferee of recoverable property under 11 U.S.C. § 550(a). This section differentiates between "initial" and subsequent transferees of such property. Only a

subsequent transferee may be shielded from this liability by the "good faith purchaser for value" exception of § 550(b). See *In re Still*, 963 F.2d 75, 27 C.B.C.2d 19 (5th Cir. 1992). Moreover, a good faith purchaser may only retain fraudulently transferred property to the extent of the value given in exchange. See *Gill v. Maddalena (In re Maddalena)*, 176 B.R. 551, 556 (Bankr. C.D. Cal. 1995) (citing § 548(c)). An initial transferee, as well as a subsequent transferee who cannot benefit from the provisions of § 550(b), may qualify for protection under the state law doctrines of a holder in due course or a *bona fide* purchaser. However, a holder in due course or a *bona fide* purchaser under state law may still be subject to a fraudulent conveyance or other actions brought under a federal statute such as the Bankruptcy Code. The FDIC and the RTC, potentially the largest sellers of distressed claims in the world, enjoy holder in due course status under federal law and that status may survive attacks under the Bankruptcy Code. See, e.g., *In re CTS Truss, Inc.*, 868 F.2d 146, 150, 20 C.B.C.2d 1292, 1297-98 (5th Cir. 1989) (dicta); but see *FDIC v. Houde*, 90 F.3d 600 (1st Cir. 1996) (stating that the federal holder-in-due course doctrine is in doubt). Private investors purchasing claims from the FDIC or the RTC could also be treated as federal holders in due course. See, e.g., *Porras v. Petroplex Sav. Ass'n*, 903 F.2d 379, 381 (5th Cir. 1990); *Federal Deposit Ins. Corp. v. Newhart*, 892 F.2d 47, 50 (8th Cir. 1989). But see *Federal Deposit Ins. Corp. v. Percival*, 752 F. Supp. 313 (D. Neb. 1990) (applying Nebraska law); *In re Woodstone Ltd. P'ship*, 25 C.B.C.2d 1638, 133 B.R. 678 (Bankr. E.D.N.Y. 1991), *rev'd on other grounds*, 149 B.R. 294 (E.D.N.Y. 1993).

(n21)Footnote 20. Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 *Cardozo L. Rev.* 1, 16-17 (1990).

(n22)Footnote 21. See *Soderberg v. Gens*, 652 F. Supp. 560, 563 (N.D. Ill. 1987) (current owner was denied standing in a fraud action under the securities laws in the absence of an express assignment of the cause of action from the original owner); *Amerifirst Bank v. Bomar*, 757 F. Supp. 1365 (S.D. Fla. 1991) (express assignment of cause of action under securities law provides standing to assignee); *Farey-Jones v. Buckingham*, 132 F. Supp. 2d 92, 100-101 (E.D.N.Y. 2001) (although 10(b) claims are not automatically assignable, express assignments may be made).

(n23)Footnote 22. In addition, an investor in a troubled company may find itself unable to sit on a creditors' committee and thereby affect the outcome of the plan negotiations, while at the same time continue trading in the debtor's securities. For a discussion of the applicable restrictions, see P 5.04[3] *infra*.

(n24)Footnote 23. See P 1.05 *supra* for a discussion of the automatic stay.

(n25)Footnote 24. 11 U.S.C. § 362(d)(1).

(n26)Footnote 25. See *Norwest Bank Worthington v. Ahlers*, 485 U.S. 197, 108 S. Ct. 963, 99 L. Ed. 2d 169, 18 C.B.C.2d 262 (1988).

(n27)Footnote 26. See 4 *Collier on Bankruptcy*, P 506.04 (Matthew Bender 15th Ed. Revised); *Hassen Imports P'ship v. KWP Fin. VI (In re Hassen Imps. P'ship)*, 256 B.R. 916 (B.A.P. 9th Cir. 2000); *In re Laymon*, 958 F.2d 72 (5th Cir. 1992), *reh'g denied*, 964 F.2d 1145 (5th Cir.), *cert. denied sub nom. Crozier v. Bradford*, 506 U.S. 917, 113 S. Ct. 328, 121 L. Ed. 2d 247 (1992); *In re Anderson*, 833 F.2d 834, 836 (9th Cir. 1987); *Grundy Nat'l Bank v. Tandem Mining Corp.*, 754 F.2d 1436, 1441, 12 C.B.C.2d 264, 270 (4th Cir. 1985). See also *In re 139-141 Owners Corp.*, 306 B.R. 763 (Bankr. S.D.N.Y. 2004), *aff'd in part, vacated in part (on different grounds), and remanded*, 313 B.R. 364 (S.D.N.Y. 2004) (holding that the debtor failed to establish equitable circumstances justifying the denial of an oversecured creditor's claim to postpetition interest at the default rate); *In re Liberty Warehouse Assocs. Ltd. P'ship*, 220 B.R. 546 (S.D.N.Y. 1998) (holding that an oversecured creditor was entitled to postpetition default interest on a loan that matured prepetition); *Florida Asset Fin. Corp. v. Dixon (In re Dixon)*, 228 B.R. 166, 172 (W.D. Va. 1998) (where circumstances necessitating an equitable deviation are absent and the contract interest rate does not violate state usury laws, function as a penalty or exceed the value of the collateral, the presumption in favor of the contract rate has not been rebutted). However, in *Hassen Imports*, the court held that an oversecured creditor was not entitled to postpetition default interest absent proof that such rate was equivalent to actual loss. Cf. *In re Boulders on the River, Inc.*, 169 B.R.

969, 974-75 (*Bankr. D. Or.* 1994) (concluding that the court has the flexibility to determine what interest rate should be applied).

(n28)Footnote 27. See *In re PPI Enters.*, 228 B.R. 339 (*Bankr. D. Del.* 1998) , *aff'd*, 324 F.3d 197 (3d Cir. 2003) (stating that there is a line of cases allowing unsecured creditors to collect postpetition interest from solvent debtors under section 1129(b)(2)).

(n29)Footnote 28. See 11 U.S.C. § 1121(d)(2)(A) & (B), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n30)Footnote 29. See 11 U.S.C. § 1121(d)(2)(A) & (B), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n31)Footnote 30. See P 7.04[3][a] *supra*.

(n32)Footnote 31. A controlling shareholder, however, may continue to influence the management of a solvent company through election of its directors. See P 7.03[2][a] *supra*.

(n33)Footnote 32. See Report of the Committee on the Judiciary, H.R. Rep. No. 109-31, pt. 1, to accompany S. 256, 109th Cong., 1st Sess., § 442 (2005).

(n34)Footnote 33. See, e.g., *In re Parker Grande Dev., Inc.*, 64 B.R. 557 (*Bankr. S.D. Ind.* 1986) ; *In re Evans*, 48 B.R. 46 (*Bankr. W.D. Tex.* 1985) . *In re Adelphia Communications Corp.*, 336 B.R. 610 (*Bankr. S.D.N.Y.* 2006) .

(n35)Footnote 34. See, e.g., *In re Ionosphere Clubs, Inc.*, 22 C.B.C.2d 1583, 113 B.R. 164 (*Bankr. S.D.N.Y.* 1990) . *In re Nat'l Staffing Servs., LLC*, 338 B.R. 31 (*Bankr. N.D. Ohio* 2005) ; *In re New Orleans Paddlewheels, Inc.*, 350 B.R. 667 (*Bankr. E.D. La.* 2006) .

(n36)Footnote 35. See 11 U.S.C. § 1104(a), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n37)Footnote 36. 11 U.S.C. § 1104(e), added by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n38)Footnote 37. See H.R. Rep. No. 109-31, *supra* n.32, § 442. The Committee Report further notes that:

Practice under Chapter X of the Bankruptcy Act of 1898 demonstrated that routine appointment of trustees deters the use of reorganization statutes and increases the likelihood that by the time a company resorts to bankruptcy relief, it must liquidate. It is therefore important for section [1104(a)(3)] to be used only for cases that would otherwise be dismissed or converted to chapter 7, and not as an alternative method for attaining the appointment of a chapter 11 trustee.

Id.

(n39)Footnote 38. See, e.g., *In re Gilman Servs., Inc.*, 46 B.R. 322, 12 C.B.C.2d 27 (*Bankr. D. Mass.* 1985) ; see also *In re Gliatech, Inc.*, 305 B.R. 832, 836 (*Bankr. N.D. Ohio* 2004) (holding that a creditor can not use estate resources to appoint an examiner that will suit its purposes only and noting that some circuits and bankruptcy courts, such as the Sixth Circuit, consider the appointment of an examiner to be mandatory when the § 1104(c)(2) \$5,000,000 qualifying debt threshold has been met).

(n40)Footnote 39. *See, e.g., 11 U.S.C. § 363* (any action deemed not "in the ordinary course" of the debtor's business requires court approval).

(n41)Footnote 40. *See, e.g., In re Xonics, Inc., 99 B.R. 870, 876 (Bankr. N.D. Ill. 1989)*.

(n42)Footnote 41. *See P 7.03[2][b][i] supra*.

(n43)Footnote 42. *Id.*

(n44)Footnote 43. However, even if its voting power would otherwise be sufficient to block the debtor's plan, the investor's vote may not be counted in certain circumstances. *See P 7.03[2][b][iii] supra*.

(n45)Footnote 44. Conversely, if the investors in a class will not receive or retain any property under the plan, they are deemed to have rejected the plan. *11 U.S.C. § 1126(g)*.

(n46)Footnote 45. *11 U.S.C. § 1124*. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 deleted paragraph (3) of section 1124, which provided that a class of claims or interests is unimpaired (and therefore not entitled to vote on the plan) if the plan provides for the payment in cash on the effective date of the allowed amount of the claim. This deletion was made to avoid the result reached in *In re New Valley Corp., 168 B.R. 73 (Bankr. D.N.J. 1994)*, in which the court found that unsecured creditors of a solvent debtor who were paid the allowed amount of their claims in cash on the effective date of the plan were not entitled to postpetition interest because their claims were unimpaired under section 1124(3). 140 Cong. Rec. H10768 (daily ed. October 4, 1994). The effect of the deletion of paragraph (3) is to permit creditors who are not paid postpetition interest to vote against the plan.

(n47)Footnote 46. This had been a particular problem for acquirors of debt that had been issued in an exchange offer. A ruling of the Bankruptcy Court for the Southern District of New York, subsequently reversed by the Court of Appeals for the Second Circuit, had determined that the amount by which the face value of a new debt security issued in an exchange offer exceeds the fair market value at the time of exchange of the old debt securities surrendered constitutes original issue discount and, to the extent unamortized as of the petition date, is considered unmatured interest and not allowable as a claim in bankruptcy. *See In re Chateaugay Corp., 22 C.B.C.2d 530, 109 B.R. 51 (Bankr. S.D.N.Y. 1990)*, *aff'd*, 130 B.R. 403 (S.D.N.Y. 1991), *aff'd in part and rev'd in relevant part*, 961 F.2d 378, 26 C.B.C.2d 1174 (2d Cir. 1992). The Court of Appeals for the Second Circuit's reversal has substantially mitigated, at least in the case of face-for-face debt exchanges, the effect of the lower court rulings. *See P 5.13[2] supra* for a discussion of these decisions.

(n48)Footnote 47. *11 U.S.C. § 1129(b)(1)*.

(n49)Footnote 48. H. R. Rep. No. 595, 95th Cong., 1st Sess. 416-17 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n50)Footnote 49. *11 U.S.C. § 1129(b)(2)(A)*.

(n51)Footnote 50. *See In re San Felipe @ Voss, Ltd., 115 B.R. 526, 529-30 (S.D. Tex. 1990)* (stating that courts must examine both whether substituted securities fully compensate the holder and the likelihood that such securities will be paid).

(n52)Footnote 51. *11 U.S.C. § 1129(b)(2)(B)*. Requirement (ii) may, in certain cases, be satisfied when a claim junior to such class receives a nominal distribution under the plan. *See, e.g., In re the Adoption of Prepackaged Chapter 11 Case Guidelines, General Order 203, Amending General Order 201 (Bankr. S.D.N.Y. February 24, 1999)*, Part III.D.(i). For a discussion of those guidelines, *see P 6.08[4]*. In addition, in the case of individual debtors, the debtor may retain property included in the estate pursuant to section 1115. *See 11 U.S.C. § 1129(b)(2)(B)*, as amended by Pub. L. No. 109-8 (2005), effective in cases filed on or after April 20, 2005.

(n53)Footnote 52. 11 U.S.C. § 1129(b)(2)(C).

(n54)Footnote 53. All investors in a particular class, absent agreement otherwise, must receive the same treatment in the plan of reorganization. 11 U.S.C. § 1123(a)(4).

(n55)Footnote 54. Of course, an investor can contest the classification of its claim in the plan proposed by the debtor. The courts do not give the debtor a free reign in this matter. *See, e.g., In re Northeast Dairy Coop. Fed'n, Inc.*, 73 B.R. 239 (Bankr. N.D.N.Y. 1987) (the court will not confirm a plan where classification of claims serves to manipulate and defeat the Bankruptcy Code's goal of equal treatment of similarly situated creditors).

(n56)Footnote 55. *See, e.g., Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 60 S. Ct. 1, 84 L. Ed. 110 (1939) .

(n57)Footnote 56. In *Bank of Am. Nat'l Trust and Sav. Ass'n v. 203 N. LaSalle St. P'ship* (In re 203 N. LaSalle St. P'ship), 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999) , the Supreme Court declined to make a finding with respect to whether the absolute priority rule includes a new value exception, and instead limited its holding to state that "on any reading [the] proposed plan fails to satisfy the statute." *In re 203 N. LaSalle St. P'ship*, 526 U.S. at 443, 119 S. Ct. at 1417 . In examining similar plans, circuit courts have split on whether to recognize a new value exception. For examples of cases declining to apply the new value exception, *see Coltex Loop Cent. Three Partners, L.P. v. BT/SAP Pool C Assocs.* (In re Coltex Loop Cent. Three Partners, L.P.), 138 F.3d 39 (2d Cir. 1998) (declining to apply new value exception to confirm plan, and instead finding that the cramdown plan under which the debtor's equity holders would retain the debtor's primary asset in return for new capital contribution violated the absolute priority rule) and *In re Bryson Props.*, XVIII, 961 F.2d 496, 505 (4th Cir. 1992) , *cert. denied*, 506 U.S. 866, 113 S. Ct. 191, 121 L. Ed. 2d 134 (1992) ("[E]ven if some limited new capital exception were viable under the Bankruptcy Code, it would not be so expansive as to apply under the facts of this case."). Other courts have explicitly recognized the new value exception. *See, e.g., Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship* (In re 203 N. LaSalle St. P'ship), 126 F.3d 955, 966-67 (7th Cir. 1997) , *rev'd*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999) ("[T]he new value corollary remains a part of our bankruptcy jurisprudence.") and *Bonner Mall Partnership v. U.S. Bancorp Mortgage Co.* (In re Bonner Mall Partnership), 2 F.3d 899, 908 (9th Cir. 1993) , *cert. granted*, 510 U.S. 1039, 114 S. Ct. 681, 126 L. Ed 2d 648 (1994) , *vacatur denied and appeal dismissed as moot*, 513 U.S. 18, 115 S. Ct. 386 (1994) (concluding that "the new value exception is fully consistent with the structure and underlying policies of Chapter 11.").

(n58)Footnote 57. *See, e.g., Haines, The Unwarranted Attack on New Value*, 72 Am. Bankr. L. J. 387 (1998).

(n59)Footnote 58. *See, e.g., Miller, Bankruptcy's New Value Exception: No Longer a Necessity*, 77 B.U. L. Rev. 975 (1997).

(n60)Footnote 59. *See, e.g., In re Bolton*, 188 B.R. 913 (Bankr. Vt. 1995) ; *Case v. L.A. Lumber Prods. Co.*, 308 U.S. 106, 121-22, 60 S. Ct. 1, 10, 84 L. Ed. 110, 122-23 (1939) .

(n61)Footnote 60. 190 B.R. 567 (Bankr. N.D. Ill. 1995) , *modified and aff'd*, 195 B.R. 692 (N.D. Ill. 1995) , *aff'd*, 126 F.3d 955 (7th Cir. 1997) , *cert. granted*, 523 U.S. 1106, 118 S. Ct. 1674, 140 L. Ed. 2d 812 (1998) , *rev'd*, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999) ["LaSalle"].

(n62)Footnote 61. *See P 7.04[9][d][ii] supra* for further discussion of the fair and equitable requirement.

(n63)Footnote 62. 526 U.S. 434, 454, 119 S. Ct. 1411, 1422, 143 L. Ed. 2d 607, 623, 41 C.B.C.2d 526, 537 (1999) .

(n64)Footnote 63. *See, e.g., Miller, Rapisardi, Greene, Leaving Old Questions Unanswered and Raising New Ones: The Supreme Court Furthers the New Value Controversy in Bank of America National Trust & Savings Ass'n v. 203 North LaSalle Street Partnership*, 30 U. Mem. L. Rev. 553 (2000); Hamilton, *The Absolute Priority Rule and New Value: Before and After Bank of America National Trust and Savings Association v. 203 North LaSalle Street*

Partnership, 105 Com. L.J. 331 (2000); Hoang, *The New Value Exception to the Absolute Priority Rule After In Re 203 N. LaSalle Street Partnership: What Should Bankruptcy Courts Do, and How Can Congress Help?*, 149 U. Pa. L. Rev. 581 (2000).

(n65)Footnote 64. See, e.g., *In re Global Ocean Carriers Ltd.*, 251 B.R. 31 (Bankr. D. Del. 2000) ; *In re Kaplan Breslaw Ash, LLC*, 264 B.R. 309 (Bankr. S.D.N.Y. 2001) .

(n66)Footnote 65. *In re PWS Holding Corp.*, 228 F.3d 224, 239 (3d Cir. 2000) .

(n67)Footnote 66. Nicholas L. Georgakopoulos, *New Value, After LaSalle*, 20 Bank. Dev. J. 1, 12 (2003).

(n68)Footnote 67. *In re Situation Mgmt. Sys., Inc.* 252 B.R. 859, 866 (Bankr. D. Mass. 2000) .

(n69)Footnote 68. See *In re Alta+Cast, LLC*, 52 C.B.C. 2d 720, *4 (Bankr. D. Del. Mar. 2, 2004) (stating that *LaSalle* mandated that shareholders do not have an exclusive right to invest in the debtor, but holding that when unsubordinated creditors along with outsiders are given a right to invest, the mandate of *LaSalle* is met).

(n70)Footnote 69. See Fortgang & Mayer, *Trading Claims and Taking Control of Corporations in Chapter 11*, 12 *Cardozo L. Rev.* 1 (1990) ["Fortgang & Mayer"]; P 7.04[3][c] *supra* .

(n71)Footnote 70. 11 U.S.C. § 548, as amended by Pub. L. No. 109-8 (2005), effective in cases filed on or after April 21, 2006. In bankruptcy cases filed before April 21, 2006, avoidance powers are limited to transfers made within one year before the filing of the petition. Following the effectiveness of the amendment, the trustee or other avoiding party may seek to avoid any transfer made within two years before the date of the filing of the petition. Further, under applicable state law, this "period of vulnerability" may be extended further. In New York, e.g., the statute of limitations to recover or void fraudulent conveyances is six years. See N.Y. CPLR § 213(8). For a discussion of fraudulent conveyances, see P 4.06 *supra*.

(n72)Footnote 71. 11 U.S.C. § 510. See generally Herzog & Zweibel, *The Equitable Subordination of Claims in Bankruptcy*, 15 Vand. L. Rev. 83, 90-112 (1961). But see *Springfield Associates, L.L.C. v. Enron Corp. (In re Enron)*, Case No. 06 (Civ. 7828 (SAS), Slip Copy, 2007 WL 2446498 (S.D.N.Y. Aug 27, 2007) , vacating a bankruptcy court decision that held that claims held by a transferee could be subordinated based solely on the conduct of the transferor. The court held that, subject to certain exceptions, the nature of a claim transfer may determine whether the claim can be equitably subordinated based on the conduct of the transferor. The court reasoned that the claim of a transferee that acquired a claim by assignment, as opposed to by sale, may be subject to equitable subordination because equitable subordination is a personal disability of a particular claimant, and does not travel with the claim. Because an assignee "stands in the shoes" of the assignor, taking "whatever limitations it had in the hands of the assignor", the claim travels with the claim only when the claim is assigned. *Id.* at 21. The court noted that open market sales of claims are "indisputably sales", which would therefore not be subject to equitable subordination based on the acts of the transferor. *Id.* at 45, n.104.

(n73)Footnote 72. See *Fortgang & Mayer*, n.69 *supra*, at 11.

(n74)Footnote 73. *In re Chateaugay Corp.*, n.46 *supra*.

(n75)Footnote 74. 11 U.S.C. § 502(b)(2).

(n76)Footnote 75. 11 U.S.C. § 502(b)(6).

(n77)Footnote 76. 11 U.S.C. § 502(b)(7).

(n78)Footnote 77. For a discussion of committees in general see P 1.04[3] and 5.04 *supra* .

(n79)Footnote 78. *11 U.S.C. § 1102(b)(3)(A)*.

(n80)Footnote 79. *336 B.R. 187 (Bankr. S.D.N.Y. 2006)* .

(n81)Footnote 80. *See P 5.04[3] supra*.

(n82)Footnote 81. *Fed R. Bankr. P. 2019(a)(4)*.

(n83)Footnote 82. *2007 WL 609214, *3 (Bankr. S.D.N.Y. Feb. 26, 2007)* The committee filed a motion to allow the disclosure to be made under seal, arguing that the pricing information amounted to confidential trade secrets protected by *Section 107(b) of the Bankruptcy Code*. The court denied the motion to file under seal, stating that stockholders not on the committee have a right to make an informed decision as to whether the committee could represent their interests or if they should form a more broadly based committee of their own.

(n84)Footnote 83. *In re Scotia Development LLC*, Case No. 07-20027-C-11 (Bankr. S.D. Tex. Apr. 18, 2007).



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Collier Business Workout Guide

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CHAPTER 7 Investing in a Troubled Company

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P 7.05 Acquiring Assets of a Troubled Company.

[1] Overview.

For a variety of reasons, investors in a troubled company (particularly strategic investors) may prefer to structure their investment as an asset acquisition. If the seller is not already in bankruptcy, one of the first issues to deal with is whether the acquisition should be done in or out of bankruptcy. The seller may have strong views about the timing of the acquisition, especially if the sale is part of the seller's efforts to avoid a bankruptcy filing.

For the purchaser, a post-filing acquisition has certain disadvantages. First, the bankruptcy filing might disrupt and cause damage to the business to be acquired. Second, asset sales in bankruptcy are subject to court approval and other procedural conditions that are not applicable to out of court acquisitions. Furthermore, bankruptcy sales are vulnerable to challenge by additional constituencies (such as the official unsecured creditors' committee appointed in a chapter 11 case) that only have standing as a result of the bankruptcy filing. The purchaser may find that a pre-filing acquisition has a greater likelihood of success than a post-filing acquisition.

In many cases, however, the disadvantages of a post-filing acquisition will be outweighed by the risk that a pre-filing acquisition will be attacked as a fraudulent conveyance.ⁿ¹ Although the significance of that risk will vary depending on the facts of each case, it will generally be higher if the assets to be sold have not been aggressively marketed by the seller. In addition to that risk, in a pre-filing acquisition, as a practical matter, it may be more difficult for the purchaser not to assume certain liabilities of the seller related to the business being sold (such as employee-related liabilities) if the purchase price is not sufficient to cover those liabilities. In particular, secured creditors may not release their liens on the assets sold, and third parties may refuse to give required consents to the sale, unless they are paid in full. By contrast, in a post-filing acquisition, the purchaser may enjoy greater protection against liabilities that have not been assumed by contract, even if these liabilities cannot be satisfied with the sale proceeds.

This section focuses on asset sales in bankruptcy pursuant to *section 363 of the Bankruptcy Code*, outlining the main features and procedural conditions applicable to those sales as well as certain advantages and risks associated with those sales for potential purchasers. In addition, this section discusses break-up fees and other types of bid protections available to purchasers and highlights certain due diligence considerations for purchasers dealing with a chapter 11 seller.

[2] Section 363.

[a] In General.ⁿ²

Section 363 of the Bankruptcy Code allows a debtor, after notice and a hearing, to sell assets, outside the ordinary course of its business, free and clear of most claims and encumbrances.ⁿ³

A key feature of a sale under section 363 is that it is not required to take place as part of a confirmed plan of reorganization. In practice, prior to its bankruptcy filing, a debtor will often negotiate and execute, a letter of intent or a definitive agreement providing for the sale, and agree with the proposed purchaser to file for bankruptcy protection and seek court approval of the sale shortly thereafter. This timing greatly benefits the purchaser, who does not need to be concerned with the allocation of the sale proceeds among the creditors of the seller, which will be dealt with as part of the often lengthy process of formulating the seller's plan of reorganization. In addition, announcing the proposed sale simultaneously with the bankruptcy filing may minimize the negative consequences of the filing on the business to be sold.

If the sale covers substantially all of the debtor's assets, this expedited timing may raise concerns, particularly from creditors who do not expect to be paid in full from the proceeds of the sale. The argument made against using the section 363 process in that context turns on the risk that the section 363 process will deprive parties of rights that they would otherwise have had if the sale were approved as part of a plan of reorganization. These rights include the right to receive a disclosure statement, the right of impaired creditor classes to vote on the plan and the right of creditors to receive at least what they would have received in a liquidation.ⁿ⁴ In practice, a sale of substantial assets of a debtor under section 363 will generally be allowed if the debtor demonstrates a sound business justification for the sale and the terms of the sale do not dictate the terms of any future plan of reorganization.ⁿ⁵

Another key feature of section 363 sales is that the purchaser may benefit from the protection granted to a good faith purchaser of the assets against the reversal or modification on approval of the decision approving the sale unless the decision has been stayed pending appeal.ⁿ⁶ Good faith status will generally be accorded to the purchaser in an arms' length transaction where no fraud or collusion with the debtor is involved.ⁿ⁷

[b] Procedural Conditions.**[i] Notice and Hearing.ⁿ⁸**

A sale under section 363 must be approved by the bankruptcy court after notice and a hearing. A hearing may not be required if notice was proper and no party in interest requests a hearing.ⁿ⁹ However, even if there are no objections and particularly if the assets to be sold are valuable, potential purchasers would be advised to request a hearing to ensure the finality of the transaction.ⁿ¹⁰

The notice and hearing requirement has two important consequences for the purchaser. First, the terms of the sale will be public and all interested parties, including secured creditors, the official creditors' committee appointed in the case and parties who have expressed an interest in the assets to be sold, will have an opportunity to scrutinize and object to the sale. Because of their ability to inject themselves into the process and therefore significantly delay it, it is important that the process be transparent and that the debtor involve all relevant constituencies as early as possible to ensure their support for the sale. Issues on which the creditors' committee and other parties in interest may have strong views include (i) the proposed purchase price, (ii) the desirability of a section 363 sale process as opposed to a plan process, (iii) the proposed timetable for the hearing on the bid protections and the sale itself (the concern being that interested parties may not have sufficient time to evaluate the proposed sale as well as other available options), and (iv) the proposed bid protections.ⁿ¹¹

Second, until the bankruptcy court approves the sale, the debtor is not bound to sell the assets to the purchaser and can unilaterally decide to sell the assets to a third party, even if a definitive agreement has been negotiated and executed. On

the other hand, the agreement is binding on the potential purchaser and can only be terminated by the potential purchaser in accordance with its terms.

[ii] Auction.

In deciding whether to approve the sale, the court must determine whether the proposed transaction reflects the highest value for the assets being sold.ⁿ¹² To make the necessary showing, in addition to any traditional shopping of the assets prior to its bankruptcy filing, the debtor will usually conduct an auction and invite other interested parties to submit competing bids. At the conclusion of the auction, the debtor will represent that the sale of the assets to the winner of the auction (which may or may not be the initial proposed purchaser, commonly called the "stalking horse") will provide the highest and best price for the assets being sold and is in the best interest of the estate.

The overarching rule in bankruptcy auctions is that the party prepared to pay the most for the assets will win.ⁿ¹³ Consequently, even where a purchase agreement has been executed between a prospective purchaser and the debtor, there can be no assurance that the prospective purchaser will in fact succeed in acquiring the debtor's assets.

Acting as a stalking horse offers certain advantages, including the opportunity to conduct more extensive due diligence, to set a threshold price for the assets and to influence the structure of the transaction. However, in order to compensate the stalking horse for subjecting itself to the particular risks of a bankruptcy auction, debtors commonly agree on the structure of the competitive bidding or the "bidding procedures" with the stalking horse in connection with the negotiation of the sale agreement and frequently offer the stalking horse certain protections as part of the process. The payment of a fee, known as a "break-up" fee, in the event of a sale to another party is the best known of these protections. But the break-up fee is not the only or, in some circumstances, the most important protection available to a stalking horse. Other features of the negotiated bidding procedures--related to, for example, the timing of the process or the qualification of competing bidders and bids--may actually have more impact on the outcome of the auction.

[3] Bid Protections.

[a] In General.ⁿ¹⁴

In light of the risks involved in acting as a stalking horse, prospective purchasers are understandably reluctant to spend the time and money necessary to conduct due diligence and engage in negotiations with the debtor without receiving some comfort that the transaction will succeed or, if it fails, that they will be compensated for their efforts.

The perspectives of the debtor and the stalking horse on bid protections are not hard to predict. The stalking horse wants as large a break-up fee and as restrictive bid procedures as can be extracted from the debtor and successfully cleared with major creditors and the bankruptcy court. The larger the fee, the more difficult it will be to top the stalking horse's offer, and the softer the blow will be if the stalking horse is nonetheless outbid. The more restrictive the bid procedures, the more difficult it will be for competing bidders to participate in the auction process. The debtor, in contrast, wants the smallest fee and the least restrictive bid protections acceptable to the stalking horse for precisely the opposite reasons.

The perspective of creditor groups is more complex and may depend on their position in the capital structure and the price offered by the stalking horse. Senior creditors that are to be paid in full out of the consideration offered by the stalking horse are likely to be focused primarily on the speed and certainty of the sale process. They want a closing and they want it as soon as possible. Given these goals, their perspective on the break-up fee and other bid protections may be similar to that of the stalking horse. A large break-up fee and restrictive bid procedures that shield the stalking horse from competition and the attendant delay and uncertainty may be acceptable to them. More junior creditors that will not be paid in full if the stalking horse prevails will almost certainly be focused on price and stimulating the competitive bidding that is most likely to maximize price. For them, a large break-up fee and restrictive bid procedures are highly undesirable because of their chilling impact on bidding. As a result, junior creditors--often in the form of an official

committee of unsecured creditors--are frequently the most vociferous opponents of a substantial break-up fee and restrictive bid procedures.

Who prevails in the negotiations over the size of a break-up fee and the restrictiveness of bid procedures will likely depend on several factors. Ultimately, the most important factor in the outcome of these negotiations may be the degree to which the debtor is compelled to sell the assets in question and the extent to which there are likely buyers other than the stalking horse. Other factors, such as the complexity of the transaction and the adequacy of the purchase price offered by the stalking horse, will also be relevant.

Properly-structured bid protections should provide a purchaser with an incentive to come forward and make the first offer to acquire the assets to be sold, thereby setting a minimum price which can be used by the debtor to solicit and evaluate higher and better offers.ⁿ¹⁵ Therefore, bid protections, if properly structured, benefit the debtor by promoting competitive bidding for, and maximizing the value of, its assets. Beyond a certain point, however, buyer protection devices may chill the bidding process by deterring other purchasers from coming forward.ⁿ¹⁶ For example, where the payments to be made to an unsuccessful purchaser are unreasonably high in relation to the price of the transaction, other prospective purchasers are disadvantaged at the outset, because the cost of acquiring the debtor's assets may become prohibitive.

Bid protections are customarily included in the letter of intent or purchase agreement signed by the parties. Because the debtor will not be bound by the terms of the letter of intent or agreement sale until the auction has taken place and court approval has been obtained, the debtor will usually file a motion seeking court approval of the bid negotiated by the parties prior to the auction and the hearing on the sale. The letter of intent or purchase agreement should provide a specific timetable within which (i) the motion seeking approval of the bid protections and the sale must be filed and (ii) court approval of the bid protections and the sale must be obtained. These provisions are intended to give the prospective purchaser the option to terminate the contract if the process is delayed. As with the terms of the sale, creditors' committees and other parties in interest will have the right to object to the bid protections.

[b] Break-up Fees.

Stalking horses almost always seek compensation in the event that the debtor ultimately makes a deal with a competing bidder. The compensation typically takes the form of a break-up feeⁿ¹⁷ or a fixed payment by the debtor to the stalking horse in the event that the transaction does not take place for specified reasons.

A debtor and stalking horse must consider and resolve several issues in structuring a break-up fee.

[i] Amount of Fee.

Both the law and practice provide relatively clear guidelines as to the size of the fee. Break-up fees are typically based on the purchase price, and the generally-accepted range is between one and three percent.ⁿ¹⁸

[ii] Trigger Events.

The right to a break-up fee is almost always tied to the termination of the sale agreement. Sale agreements, however, frequently contain numerous termination provisions, not all of which are appropriate triggers for the payment of a substantial break-up fee. The debtor and the stalking horse must agree on which termination events will trigger the payment of the break-up fee and which will not.

Termination triggered by the default of the stalking horse should not entitle the stalking horse to a break-up fee. Conversely, a termination based on the debtor's sale of the assets in question to a competing bidder making a higher and better offer implicates the core purpose of the break-up fee and should entitle the stalking horse to payment. Between

these two ends of the spectrum, however, there is fertile ground for debate.^{18.1}

For example, there are many ways a debtor may break up the original deal. A debtor may reorganize without a sale, voluntarily dismiss the bankruptcy case, convert the case to a Chapter 7 proceeding or liquidate in Chapter 11. Any one of these options is a strategic option that the debtor may pursue instead of consummating the original transaction with the stalking horse. The debtor and the stalking horse must decide which, if any, of these will trigger the payment of the break-up fee. In addition, the parties must also determine at what point an alternative transaction is sufficiently concrete to warrant payment. Must the alternative transaction be consummated? Is it sufficient that the bankruptcy court has authorized the transaction? Should the stalking horse's right to the fee mature as soon as the debtor has taken concrete action--board approval, public announcement or execution of a binding agreement, for instance--in furtherance of the alternative transaction?

One way to address concerns about debtor manipulation of termination provisions commonly found in non-bankruptcy transactions and sometimes used in bankruptcy sales is to add a "tail" provision to the sale agreement. A tail provision typically provides that if an alternative transaction is consummated within a specified period after the termination of the sale agreement, the payment of a break-up fee to the stalking horse is triggered. A tail provision is based on the assumption that if an alternative transaction is consummated shortly after the termination of the sale agreement, it can fairly be assumed that the two events--the termination of the sale agreement and the alternative transaction--are related.

[iii] Timing of Payment.

Break-up fees are often payable promptly following the event giving rise to the fee. But this need not be the case, and in many instances, it may be important for the debtor to negotiate a later payment date.

Debtors are often liquidity constrained. Payment of a substantial fee out of existing resources may be difficult or even impossible. The debtor can avoid this problem--at least where the event triggering the break-up fee is an alternative transaction--if the obligation to pay the break-up fee does not mature until the alternative transaction is consummated. When this occurs the debtor can use the proceeds of the alternative transaction, rather than its limited existing resources, to fund payment.

Such a delay in payment, of course, raises a number of issues for the stalking horse. First, the stalking horse may press for immediate payment of the break-up fee precisely because of the pressure it places on the debtor and the debtor's ability to pursue an alternative transaction. More legitimately, the stalking horse may be concerned that a provision tying payment of the fee to the closing of the alternative transaction effectively shifts the risk of consummating the alternative transaction to the stalking horse. If the alternative transaction never closes, the break-up fee is never paid. This concern can, however, be addressed by imposing an outside date on the payment obligation. In such a structure, the debtor must pay the break-up fee on the earlier of the closing of the alternative transaction and a specified number of days following termination of the sale agreement.

[iv] Priority.

Finally, the break-up fee provision (and the court order approving the fee) should address the priority of any fee claims. There are, at least in theory, three possibilities: an administrative priority under *sections 503(b) and 507(a)(1) of the Bankruptcy Code*, a "super priority" senior to all administrative claims and a secured claim. Generally, however, the fee claim is granted administrative claim status. The authority for a "super priority" is less than clear and there are often no unencumbered assets to serve as collateral.

[c] Other Bid Protections.

[i] Expense Reimbursement.

The break-up fee may be intended to compensate the stalking horse for both its lost opportunity costs and its out-of-pocket costs in connection with the transaction. Frequently, however, the right to reimbursement for out-of-pocket expenses is dealt with separately in an expense reimbursement provision.ⁿ¹⁹

The right to reimbursement of expenses is typically limited to actual, out-of-pocket costs, and satisfactory documentary support is sometimes required. In addition, the right to reimbursement is typically capped. Unlike in the case of break-up fees, the cap is not generally based strictly on the purchase price and may instead reflect the intensity of the diligence, negotiation and structuring to be performed by the stalking horse.

Expense reimbursement is frequently paid at the same time and under the same conditions as a break-up fee. However, since expense reimbursement usually involves substantially smaller sums and is less controversial, more generous triggers are sometimes provided.

[ii] Bidding Procedures.ⁿ²⁰

As discussed above, bankruptcy law requires that the stalking horse's offer be subject to competitive bidding and the procedures governing this bidding are typically approved in advance by the bankruptcy court. In contrast to break-up fees and expense reimbursement, the focus of these procedures is not the compensation or entrenchment of the stalking horse. However, bidding procedures are generally negotiated with the stalking horse in connection with the negotiation of the sale agreement and various elements of the bidding procedures offer ample opportunity for the stalking horse to limit or inhibit competition.

[A] Timeline.

The bidding procedures set a date by which all competing bids must be received and, by implication, by which all due diligence must be concluded. A second date--usually a few days later--is set for the auction should one be required.ⁿ²¹ A third date is set for the sale hearing, which is typically a day or two later.

This timeline, and in particular, by the deadline for the submission of bids, can have a substantial impact on the ability of potential bidders to participate in auction. In most cases, a potential bidder will not have conducted any meaningful due diligence until the bidding procedures are approved by the bankruptcy court and the formal competitive bidding process commences. Consequently, the deadline for the submission of bids determines the length of time a potential bidder has to conduct due diligence. A short deadline may make it difficult and expensive, or even impossible, to complete the necessary diligence. In addition, potential bidders may also be forced to accomplish other complex and time sensitive tasks during this period. In some cases, the bidding procedures may have the effect of excluding bids conditioned on financing or regulatory approvals.

Timelines vary significantly from case to case. From the stalking horse's perspective, any substantial delay may have a negative impact on the assets and businesses it is seeking to buy. Bankrupt companies are inherently unstable, and they rarely fare well in uncertain situations. As a result, stalking horses often argue forcefully for a compressed timeline. While the debtor is also concerned about the deterioration of its business, the debtor also wants the highest price available for its assets. Too compressed a timeline may chill bidding and depress the price.

[B] Minimum Overbids.

The bidding procedures usually provide that in order to qualify as a "qualified bid" any competing offer must exceed a specified amount, referred to as the "minimum overbid."

Whether expressed as a fixed amount or a formula, the minimum overbid is usually some amount in excess of the sum of the stalking horse's offer plus the break-up fee plus the maximum permissible expense reimbursement. The

underlying assumption is that payment of the break-up fee and expense reimbursement are costs of accepting a competing offer that the competing bidder must cover.

Negotiation with the stalking horse over the minimum overbid typically focuses on the size of the additional increment above the break-up fee and expense reimbursement. The debtor should want the increment to be sufficiently large to compensate it for the frictional costs involved in switching bidders and deals. The debtor has usually invested considerable time and resources in structuring a transaction with the stalking horse and in conducting due diligence on the stalking horse's ability to consummate the transaction. The competing bidder may be an unknown quantity and there may be questions about the terms or feasibility of its offer that are difficult to resolve fully in connection with the competitive bidding process. On the other hand, the debtor will not want the increment to be so large that it chills bidding by deterring interested bidders from performing the initial investigation and other work that is a prerequisite to submitting a competing bid. The stalking horse, in contrast, will naturally seek the highest minimum overbid possible. The higher the hurdle a competing bidder must clear, the less likely it is that there will be competing bids.

[C] Additional Bidding and Credit Bidding the Break-up Fee.

The bidding procedures will provide that if a competing bidder submits a bid in excess of the minimum overbid, an auction will be held and additional bidding may occur. At the auction, the stalking horse is entitled to submit further bids and often does so. If the stalking horse participates in the bidding at the auction, a question arises as to how the stalking horse's right to a break-up fee and expense reimbursement is to be treated in connection with this bidding. Because the debtor must pay the stalking horse the break-up fee and expense reimbursement if it accepts another bidder's offer but it has no such obligation to the other bidders if it accepts the stalking horse's offer, facially comparable bids from the stalking horse and other bidders do not, in fact, yield the same return to the estate. For example, if the debtor accepts a \$100 million bid from the stalking horse, it keeps the full \$100 million. If, however, the debtor accepts a \$100 million bid from another bidder it will only keep the \$100 million less the break-up fee and expense reimbursement.

The bidding procedures sometimes deal with this question explicitly, but, surprisingly, they frequently do not.ⁿ²² The parties should be clear in advance on how it will be addressed. There are at least two basic mechanisms available. First, the debtor can permit the stalking horse to "credit bid" its break-up fee and expense reimbursement. In this scenario, a portion of each bid by the stalking horse is its break-up fee and expense reimbursement rather than cash or other more traditional consideration. Alternatively, the debtor can require--much as the minimum overbid does--that whenever a competing bidder seeks to top a bid by the stalking horse, it do so by an amount that exceeds the break-up fee and expense reimbursement.

[D] Bidder Qualification.

Bidding procedures typically limit the right to conduct due diligence and to participate in the bidding process to "qualified bidders." The crux of bidder qualification is financial capacity.ⁿ²³ to consummate a transaction. Consequently, bidding procedures generally require that a prospective bidder submit its most recent audited and unaudited financial statements.ⁿ²⁴ On occasion, the procedures require that the prospective bidder agree to submit to reciprocal due diligence by the debtor. Based on this evidence, the debtor must conclude that the bidder is "reasonably likely to consummate" a transaction or "has demonstrated the financial capability to consummate" a transaction. Objective standards are rarely used.

Other parties--the official committee of unsecured creditors, the debtor-in-possession lenders or the secured pre-petition lenders--sometimes negotiate for the right to review the financial information submitted and to be consulted with respect to the decision of whether or not to qualify a bidder. It would be highly unusual, and probably inappropriate, for the stalking horse to have any direct input into the qualification of bidders. However, on occasion, stalking horses have sought the right to review the prospective bidders' financial information. Such a request may be based on concern about

the sometimes conflicting motivations guiding the actions of the debtor in this context. In theory, at least, the debtor only wants to entertain offers from bona fide purchasers. However, as a general matter, the more competitors at an auction, the healthier the bidding and the better the final price.

[E] Bid Qualification.

Bidding procedures also typically require that competing bids meet certain minimum requirements in order to qualify for consideration. The central requirement relates to the price and the minimum overbid requirement discussed above. Bidding procedures, however, usually demand that a competing bid meet several other criteria.

Bidding procedures generally require that a competing bid include a copy of the sale agreement with the stalking horse marked to show any changes or modifications sought by the competing bidder. They often also state that a competing bid will only be considered if it is on terms that are "not materially more burdensome" than the terms of the sale agreement with the stalking horse. Another common requirement relates to the contingency or conditionality of competing offers. Bidding procedures typically require that all competing offers be irrevocable--in some cases until the sale hearing (or even the consummation of a transaction). Often, they limit the conditions to closing that a competing bid may specify, specifically precluding closing conditions based on financing, due diligence and, in some cases, regulatory approval conditions.

While both these requirements are rarely the subject of any controversy, they create a competitive opportunity for the stalking horse in many transactions. With respect to the first requirement, to the extent that the stalking horse is comfortable with less expansive representations and warranties and covenants--either because of the more extensive due diligence that it often has had an opportunity to conduct or for other reasons, it can place competing bidders in the awkward predicament of choosing between reliance on the stalking horse's judgment and requiring additional provisions that may put them at a competitive disadvantage. Similarly, the second requirement provides the stalking horse with a strategic advantage over other likely bidders--ready financing or less stringent regulatory requirements, for instance--to enshrine this advantage in the bidding procedures and thereby preclude participation by some potential competitors.

Competing offers must often be accompanied by a "good faith" deposit, which is not refundable. Such deposits are sometimes as much as 10% or 15% of the purchase price. They are intended to provide the debtor with a level of comfort concerning the good faith of competing bidders--about which the debtor may know very little--and to serve as a sort of liquidated damages provision in the event of a breach by a bidder. The stalking horse--which, as discussed above, may be concerned about the debtor's inclination to permit less than qualified bidders to submit competing bids--is likely to press for a significant deposit requirement.

[iii] Changes to Bidding Procedures and Non-Conforming Bids.

Once the debtor and the stalking horse have reached agreement on the terms of the bidding procedures, they must confront one last issue--the extent to which the debtor will be permitted to supplement or modify the procedures.

Because the auction process is fluid and unpredictable, the debtor will want the freedom to modify or supplement the procedures in response to unexpected events and problems. By contrast, the stalking horse will want to make sure that this flexibility is not used to undermine its rights. This conflict is usually resolved through a provision that permits the debtor to supplement or modify the procedures so long as it does not violate the terms of the bidding procedures order or the sale agreement. Where the stalking horse has substantial leverage in the negotiation of the bidding procedures, the consent of the stalking horse is sometimes required in connection with any material modification of the procedures.

Embedded in this question, however, is a narrower but more difficult problem. Is the debtor free to consider (and even accept) offers that do not conform to the requirements of the bidding procedures? Not surprisingly, the bidding procedures rarely deal directly with this issue. After all, the premise of the procedures is that they must be followed by

all bidders. Whether a debtor can, consistently with its obligation to obtain the "highest and best" value for its assets, refuse to consider an offer that it believes to be superior simply because it does not comply with one of the provisions of the bidding procedures remains an open question.

This issue often arises in connection with bids submitted after a bid deadline. In considering whether such bids should be entertained, courts must balance the competing considerations of ensuring the credibility and finality of auctions and maximizing the return to creditors. An older case in this area decided by the First Circuit under the former Bankruptcy Act, *In re Gil-Bern Industries*, established a bright line rule that "it is an abuse of discretion for a bankruptcy court to refuse to confirm an adequate bid received in a properly and fairly conducted sale merely because a slightly higher offer has been received after the bidding is closed."²⁵ However, more recent cases have taken a less rigid view and limited the rule when a "more complicated bidding scheme" makes it necessary to balance "the competing consideration of finality in the bidding process and fairness to the bidders against the interests of creditors in securing the highest sales price."²⁶

[d] Judicial Oversight.

The case law concerning the permissible scope of bid protections focuses almost exclusively on break-up fees. These decisions, however, may in some cases provide guidance relevant to evaluating the legality of other bid protections.

In evaluating break-up fees, different courts have settled on different standards of review.

Many courts, including the Southern District of New York, have adopted the approach developed by courts in the nonbankruptcy context (particularly in corporate takeover cases).²⁷ Following that approach, break-up fees that fall within the scope of the business judgment of debtors are presumptively valid. Relying on the business judgment rule, courts will generally authorize a break-up fee (or other device) where the relationship of the parties who negotiated the fee is free from self-dealing or manipulation, the fee encourages rather than hampers bidding, and the amount of the fee is reasonable in relation to the proposed purchase price.²⁸

Other courts, however, have ruled that the analysis of break-up fees in the bankruptcy context should be fundamentally different from that in the nonbankruptcy context.²⁹ Accordingly, these courts scrutinize the fees and protections, to see whether they truly enhance the bidding process.³⁰ Foregoing the business judgment rule, these courts look toward whether the fees further "the diverse interests of the debtor, creditors and equity holders, alike."³¹ Furthermore, they review the fees to insure that the fees do not unduly burden the debtor's estate nor impede the rights of the parties in interest.³² Judicial deference to the business judgment of the debtor is considered inappropriate because, among other things, directors' fiduciary duties are owed to different constituencies in the bankruptcy context.³³ Unlike directors of a solvent company, directors of an insolvent company may owe fiduciary duties to both shareholders and creditors, constituencies which may have quite different views on the desirability of an asset sale or on the propriety of a break-up fee. For example, shareholders may oppose an asset sale in favor of a restructuring that may allow the company to rebound in the future, but creditors may prefer an asset sale with immediate but potentially lower returns.

Both these approaches were considered and rejected by the Court of Appeals for the Third Circuit in *Calpine Corp. v. O'Brien Env't'l Energy, Inc. (In re O'Brien Env't'l Energy, Inc.)*,³⁴ In that case, O'Brien Environmental Energy, Inc. ("O'Brien") and Calpine Corporation ("Calpine"), one of three final bidders for O'Brien's assets, entered into an asset purchase agreement conditioned upon the bankruptcy court's approval of a \$2 million break-up fee and the reimbursement of \$2.25 million in related expenses. Although the bankruptcy court refused to approve the fee and expense reimbursement, a consent order stating that Calpine reserved its right to request payment of such fee and expense reimbursement was entered. Calpine participated in the auction that followed and lost to another bidder. Calpine then filed an application for payment of administrative expenses in the amount of the break-up fee and related expenses. The bankruptcy court identified at least nine factors to be considered in deciding whether to award the break-up fee and related expenses to Calpine. After weighing the various factors, the bankruptcy court concluded that

although there was no evidence of self-dealing and the fee and expenses were within the range of fees approved by some courts, allowing such a fee and expense reimbursement in this case might chill or at best complicate the bidding process. The bankruptcy court's decision was affirmed by both the district court and the Court of Appeals for the Third Circuit.

At the outset, the Court of Appeals for the Third Circuit expressly refused to develop a general common law of break-up fees and asked instead whether the Bankruptcy Code authorized the award of break-up fees for unsuccessful purchasers. Rather than adopting a list of specific factors, the court held that the break-up fee awards should meet the standard for allowing general administrative expenses under the Bankruptcy Code, namely, whether the break-up fee was actually necessary to preserve the value of the debtor's estate.ⁿ³⁵ The court agreed that break-up fees could be awarded in certain cases, but specified that such awards should be governed by specific statutory language.

Applying the above standard to the facts of the case, the court held that the \$2 million break-up fee and the reimbursement of \$2.25 million in related expenses were not actually necessary to preserve the value of O'Brien's estate and therefore that Calpine was not entitled to an administrative expense claim for those amounts. The court rejected Calpine's argument that the payment of the break-up fee and the reimbursement of its expenses were necessary to make its continued involvement worthwhile, as Calpine made its decision to participate in the auction in spite of the risk that its request for such payment and reimbursement might be denied. Furthermore, the court held that Calpine had failed to show that its bid had served as a catalyst to higher bids or that the break-up fee and related expense reimbursement induced it to serve as a "stalking horse." In that regard, it was noted that much of the information that the bidders needed to evaluate O'Brien's assets had been gathered by O'Brien at its own expense and that Calpine had strong financial incentives to undertake the cost of submitting the initial bid in the absence of any form of bid protections.

The new approach adopted by the Third Circuit in *In re O'Brien Environmental Energy, Inc.*, clearly raises the standard applicable to break-up fees and other bid protections in chapter 11 asset sales. The requirement that such protections be actually *necessary* to preserve the value of the debtor's estate (as opposed to being a matter of the business judgment rule or of furthering the interests of the debtor and its creditors and equity holders) will make it more difficult to justify such protections.ⁿ³⁶

[4] Due Diligence Considerations.

[a] In General.

A purchaser of assets from a chapter 11 seller may have little legal or practical ability to assert claims post-closing against the seller. Debtors often insist on selling the assets with limited representations and warranties that do not survive after the closing, on the ground that indemnity claims will delay the bankruptcy process. In practice, if there is a breach of representations and warranties, the purchaser could refuse to close (if the breach occurs pre-closing) or could assert an administrative claim for damages against the debtor (if the breach occurs post-closing). In addition, debtors will typically resist any type of escrow mechanism that would paralyze a portion of the sale proceeds, even for a limited period of time. Therefore, the due diligence conducted by potential purchasers in this context should be particularly thorough. Two areas of particular interest are potential sources of successor liability and assets located outside the U.S.

[b] Successor Liability.ⁿ³⁷

Section 363(f) permits the sale of property of the estate free and clear of any "interest in" such property. However, the purchaser of the property under section 363 is not automatically protected against potential successor liability related to the purchase of such property under applicable law, including successor environmental liability, successor products liability and, in some cases, liability for employment-related obligations.ⁿ³⁸ Although the importance of this risk will depend on the circumstances of each case, buyers should carefully review the potential sources of successor liability to negotiate a price adjustment if appropriate and to make sure that all potential claim holders receive sufficient notice of

their right to file proofs of claim against the debtor's estate.

[c] Foreign Assets.

Where assets located outside of the U.S. are purchased, it is important to remember that while, in theory, a U.S. bankruptcy court has jurisdiction worldwide, the court order approving the sale of those assets may not be enforceable in other jurisdictions. As a result, even if the bankruptcy court approves the sale of the foreign-located assets free and clear of all interests, the purchaser may still be liable for the claims of non-U.S. creditors of the seller against those assets. Beyond conducting thorough due diligence investigations to identify the assets and liabilities at issue, there is no easy solution to this problem.

One way of minimizing this risk is to require the seller to give notice of the proposed sale to all non-U.S. creditors of the debtor who may have interests in the foreign-located assets sold, thereby giving them an opportunity to object to the sale. In addition, the sale order can provide that no party who has received notice of the proposed sale without filing a timely objection will be entitled to challenge the sale in the U.S. bankruptcy court with jurisdiction over the debtor's chapter 11 case. If no objections are filed, the purchaser may obtain a certain comfort that the assets are free from material interests. Furthermore, if an unhappy creditor later sues the purchaser in a foreign court, the purchaser would have evidence that the creditor knew about the sale, had the opportunity to object to it, but declined to do so. However, whether that evidence will have any relevance in the foreign court is a matter of local law.

FOOTNOTES:

(n1)Footnote 1. For a good overview of fraudulent conveyance, see Cook, Ranney-Marinelli and Marafioti, *Fraudulent Transfers*, 876 PLI/Comm 511 (2005); 5 *Collier on Bankruptcy*, P 548.01 (Mathew Bender 15th Ed. Revised).

(n2)Footnote 2. 11 U.S.C. § 363(b), (f). Section 363(b) was amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, with respect to certain privacy rights of individuals. For a detailed description of § 363, see 3 *Collier on Bankruptcy*, ch. 363 (Mathew Bender 15th Ed. Revised).

(n3)Footnote 3. See P 7.05[4][b] *infra*.

(n4)Footnote 4. 11 U.S.C. §§ 1125, 1126 and 1129.

(n5)Footnote 5. For a discussion of the applicable case law, see Heroy and Domonowski, *The Purchase and Sale of Assets in Bankruptcy*, 849 PLI/Comm 957, 968-74 (2003). See also 3 *Collier on Bankruptcy*, P 363.02[4] (Mathew Bender 15th Ed. Revised).

(n6)Footnote 6. 11 U.S.C. § 363(m). See *Official Comm. of Unsecured Creditors v. Trism, Inc. (In re Trism, Inc.)*, 328 F.3d 1003 (8th Cir. 2003) ; *Development Co. of Am. v. Adamson Co. (In re Adamson Co.)*, 159 F.3d 896 (4th Cir. 1998) .

(n7)Footnote 7. See Heroy and Domonowski, *The Purchase and Sale of Assets in Bankruptcy*, 849 PLI/Comm 957, 974-76 (2003).

(n8)Footnote 8. For a detailed description of the notice and hearing requirements, see 3 *Collier on Bankruptcy*, P 363.02[1] (Mathew Bender 15th Ed. Revised).

(n9)Footnote 9. 11 U.S.C. § 102(1).

(n10)Footnote 10. Heroy and Domonowski, *The Purchase and Sale of Assets in Bankruptcy*, 849 PLI/Comm 957, 967-68 (2003).

(n11)Footnote 11. See P 7.05[3] *infra*.

(n12)Footnote 12. See *In re Integrated Res., Inc.*, 135 B.R. 746, 750 (Bankr. S.D.N.Y. 1992), *aff'd*, 147 B.R. 650 (S.D.N.Y. 1992); *In re Atlanta Packaging Prods., Inc.*, 99 B.R. 124, 130 (Bankr. N.D. Ga. 1988) ("It is a well-established principle of bankruptcy law that the objective of bankruptcy sales and the trustee's duty with respect to such sales is to obtain the highest price or greatest overall benefit possible for the estate.").

(n13)Footnote 13. In practice, however, valuating competing bids may be difficult, particularly where bids covering only a portion of the assets to be sold or providing for non-cash consideration are submitted.

(n14)Footnote 14. For a good discussion of applicable caselaw, see Samet, *Use of Break-Up and Topping Fees in Asset Sales*, 877 PLI/Comm 9 (2005); Novikoff, *Update on Recent Developments in Trading Claims and Taking Control of Corporations in Chapter 11*, SE71 ALI-ABA 197 (2000).

(n15)Footnote 15. See also 3 *Collier on Bankruptcy*, P 363.02[7] and 7*Collier on Bankruptcy*, P 1108.07[5] (Matthew Bender 15th Ed. Revised).

(n16)Footnote 16. See, e.g., *In re Tiara Motorcoach Corp.*, 212 B.R. 133, 138 (Bankr. N.D. Ind. 1997); *In re America W. Airlines, Inc.*, 166 B.R. 908, 913 (Bankr. D. Ariz. 1994).

(n17)Footnote 17. See, e.g., 13 *Bank. Dev. J.* 475 (1997) (analyzing the purpose, use, history and size of break-up fees). In sales outside of the bankruptcy context, means of protecting the purchaser other than break-up fees are sometimes used. The purchaser may negotiate a "topping fee," which is paid only if another higher bid is selected and is generally based on a percentage of the amount by which such higher bid exceeds the original purchaser's offer. See, e.g., *In re APP Plus*, 223 B.R. 870 (Bankr. E.D.N.Y. 1998) (in \$22 million transaction, court approved \$250,000 break-up fee but disallowed \$550,000 topping fee). The purchaser may also seek an option, known as a "lock-up", to purchase a valuable asset at an attractive price, sometimes referred to as a "crown jewel", upon termination. See, e.g., *In re Bidermann Indus. U.S.A.*, 203 B.R. 547 (Bankr. S.D.N.Y. 1997) (refusing to approve lock-up arrangement); *but see In re Apex Oil Co.*, 92 B.R. 847 (Bankr. E.D. Mo. 1988) (approving arrangement by which buyer's acquisition vehicle purchased option to buy claims of debtor at discount, thereby giving buyer position to lock-up transaction). These techniques are rarely used in bankruptcy sales.

(n18)Footnote 18. See *In re Hupp Indus., Inc.*, 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992) ("break-up fees ranging from one to two percent of the purchase price have been authorized by some courts"); Samet, *Use of Break-up and Topping Fees in Asset Sales*, 877 PLI/Comm 9, 18 (2005) ("courts tend to approve fees that are in the range of two to three percent of each purchase price"); *Who Wins in the Race to Get Break-up Fees approved?*, 22- 8 ABIJ 16 (2003) ("so long as the break-up fee is within the 2-3 percent range, it is unusual for [it] to be denied"). *But see, e.g., Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl. Energy, Inc.)*, 181 F.3d 527 (3d Cir. 1999) (in transaction of at least \$142 million, court refused to approve \$2 million break-up fee and \$2.25 million expense reimbursement); *In re America West Airlines*, 166 B.R. 908 (Bankr. D. Ariz. 1994) (court refused to approve \$4 million to \$8 million break-up fee, but approved \$250,000 per month expense reimbursement up to a maximum of \$3 million).

(n19)Footnote 18.1. See, e.g., *Specialty Malls of Tampa, Inc. v. Riverbank Landscape, Ltd.*, 2004 U.S. Dist. LEXIS 13572 (D.N.Y. 2004) (restricting payment of break-up fee to cases where higher bid offer was closed on, the purchase price was paid, and the bankruptcy court approved the break-up fee).

(n20)Footnote 19. See, e.g., *Calpine Corp. v. O'Brien Envtl. Energy, Inc. (In re O'Brien Envtl. Energy, Inc.)*, 181 F.3d 527 (3d Cir. 1999) (in transaction of at least \$142 million, court refused to approve \$2 million break-up fee and \$2.25 million expense reimbursement); *In re America West Airlines*, 166 B.R. 908 (Bankr. D. Ariz. 1994) (court refused to approve \$4 million to \$8 million break-up fee, but approved \$250,000 per month expense reimbursement up to a maximum of \$3 million).

(n21)Footnote 20. Where numerous asset sales are expected, to avoid the need to obtain court approval of bidding procedures for each sale, debtors sometimes seek authority to conduct asset sales pursuant to global bidding procedures

applicable to all sales within a certain price range. Similarly, for sales of assets of limited value (or *de minimis* sales) that do not warrant the conduct of an auction, debtors sometimes seek court approval of global notice procedures and other appropriate procedures to facilitate these sales.

(n22)Footnote 21. The bidding procedures usually provide--and a stalking horse should insist that they provide--that an auction will take place only if the stalking horse's offer is topped by a competing bid submitted by the bid deadline.

(n23)Footnote 22. Bidding procedures almost universally contain language that permits the debtor (often in consultation with the official committee of unsecured creditors) to consider a range of factors in selecting the winner of the auction, including providing the debtor with ample authority to take the break-up fee and expense reimbursement obligations into account in selecting the highest and best offer.

(n24)Footnote 23. Bidding procedures typically require that competing bidders enter into a standard form confidentiality agreement. A number of issues can arise in the negotiation of a confidentiality agreement, including issues related to standstill and no hire provisions. However, these are not usually issues of interest to the stalking horse so long as no competitive bidder is given access to due diligence materials on terms that are materially less restrictive than those on which the stalking horse conducted its due diligence.

(n25)Footnote 24. Where the bidder is an acquisition vehicle, the procedures typically require financials from the equity holders and a satisfactory written commitment to be responsible for the vehicle's obligations in connection with the transaction.

(n26)Footnote 25. 526 F.2d 627, 629 (1st Cir. 1975) .

(n27)Footnote 26. *In re Financial News Network, Inc.*, 980 F.2d 165, 170 (2d Cir. 1992) . See also *Four B. Corp. v. Food Barn Stores (In re Food Barns Stores, Inc.)*, 107 F.3d 558 (8th Cir. 1997) (employing sliding scale analysis based on reasonable expectations of bidders); *Corporate Assets, Inc. v. Paloian (In re GGS Liquidation, Inc.)*, 280 B.R. 425 (N.D. Ill. 2002) (adopting sliding scale approach from *Food Barns Stores*).

(n28)Footnote 27. See, e.g., *In re Global Crossing Ltd.*, 295 B.R. 726 (Bankr. S.D.N.Y. 2003) ; *In re Integrated Res., Inc.*, 135 B.R. 746 (Bankr. S.D.N.Y. 1992) , *aff'd*, 147 B.R. 650 (S.D.N.Y. 1992) , *appeal dismissed on jurisdictional grounds*, 3 F.3d 49 (2d Cir. 1993) ; and *In re 995 Fifth Ave. Assocs., L.P.*, 96 B.R. 24 (Bankr. S.D.N.Y. 1989) .

(n29)Footnote 28. See *Official Comm. of Subordinated Bondholders v. Integrated Res., Inc. (In re Integrated Res., Inc.)*, 147 B.R. 650, 657 (S.D.N.Y. 1992) (approving \$250,000 in reimbursement of expenses and authorizing up to an additional \$1.25 million for the remainder of bidder's expenses); see also *In re APP Plus*, 223 B.R. 870, 875 (Bankr. E.D.N.Y. 1998) (applying factors, including whether the fee was tainted by self-dealing and manipulation); *In re Bidermann Indus. U.S.A.*, 203 B.R. 547, 552-53 (Bankr. S.D.N.Y. 1997) (applying factors but refusing to approve fee because of manifest self-dealing); *In re Hupp Indus., Inc.*, 140 B.R. 191, 194 (Bankr. N.D. Ohio 1992) (listing seven different factors to be considered and refusing to approve fee).

(n30)Footnote 29. See, e.g., *In re America W. Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) (refusing to apply the business judgment rule and to approve fee); see also Markell, *The Case Against Breakup Fees in Bankruptcy*, 66 Am. Bankr. L.J. 349 (1992).

(n31)Footnote 30. See, e.g., *In re O'Brien Envt'l Energy, Inc.*, 181 F.3d 527, 535 (3d Cir. 1999) (refusing to apply the business judgment rule; to gain break-up fees, the requesting party must demonstrate that the fees "were actually necessary to preserve the value of the estate [pursuant to §503(b) of the Bankruptcy Code]"; *In re S.N.A. Nut Co.*, 186 B.R. 98, 101-2 (Bankr. N.D. Ill. 1995) (follows *In re America W. Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) and *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) , the latter concluding that the test as to whether to

grant break-up fees is not based on whether the fee falls within the business judgment of the debtor but, rather, whether the fee will "further the diverse interests of the debtor, creditors and equity holders, alike"); *In re Condere Corp.*, 228 B.R. 615 (Bankr. D. Miss. 1998) ; *In re Hupp Indus. Inc.*, 140 B.R. 191, 195-6 (Bankr. N.D. Ohio 1992) .

(n32)Footnote 31. *In re Lionel Corp.*, 722 F.2d 1063, 1071 (2d Cir. 1983) .

(n33)Footnote 32. *In re Hupp Indus., Inc.*, 140 B.R. 191, 196 (Bankr. N.D. Ohio 1992) ; see also *In re Tiara Motorcoach Corp.*, 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) ; *In re America W. Airlines, Inc.*, 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) .

(n34)Footnote 33. For a discussion of the fiduciary duties of directors of insolvent corporations, see P 3.03 and P 3.04 *supra* .

(n35)Footnote 34. 181 F.3d 527 (3d Cir. 1999) .

(n36)Footnote 35. 11 U.S.C. § 503(b)(1)(A).

(n37)Footnote 36. In several recent cases, bankruptcy judges sitting in the Third Circuit have refused to approve break-up fees. See Murray, *Horsewhipped*, THE DEAL, Feb. 12, 2004, (citing decisions in the bankruptcy cases of *Epic Capital Corp.*, *Top-Flite Golf Co.* and *Burlington Industries*). These cases suggest that courts may not be willing to approve break-up fees where it is not clear that the break-up fee will provide a benefit to the debtor. This might be the case, for example, where active bidding for the assets is taking place or is expected to take place, regardless of whether a break-up fee is granted to the stalking horse.

(n38)Footnote 37. See Heroy and Domonowski, *The Purchase and Sale of Assets in Bankruptcy*, 849 PLI/Comm 957, 983-98 (2003); Sloane, *The Sub Rosa Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bank. Dev. J. 37 (1999); 3 Collier on Bankruptcy, P 363.02[3] (Mathew Bender 15th Ed. Revised); Reed, *Successor Liability and Bankruptcy Sales*, The Business Lawyer, vol. 51, no. 3, at 653 (May 1996).

(n39)Footnote 38. Cases where the purchaser has acquired successor liability for the chapter 11 seller's employment-related obligations include *Chicago Truck Drivers, Helpers & Warehouse Workers Union (Indep.) Pension Fund v. Tasemkin, Inc.* 59 F.3d 48 (7th Cir. 1995) (unpaid pension contributions); and *EEOC v. Stephen T. Cox, Inc.*, 2001 U.S. Dist. LEXIS 25674 (M.D. Tenn. June 28, 2001) (employment discrimination claims). See also *New York v. N. Storonske Cooperage Co.*, 174 B.R. 366 (D.N.Y. 1994) (environmental pollution claims) and *Western Auto Supply Co.v. Savage Arms (In re Savage Indus.)*, 43 F.3d 714 (1st Cir. 1994) (products liability claims).



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P 8.01 Introduction.

This chapter will deal with the principal tax issues faced by the troubled company in restructuring its debt and the consequences of the restructuring to holders of its debt.

Structuring a workout ordinarily is highly tax sensitive. In restructuring the debt of the troubled company, the principal tax goals from the company's point of view typically are minimizing the creation of cancellation of indebtedness ("COD") income, preserving the company's net operating losses ("NOLs") and other tax attributes, and maximizing interest deductions. The holder's principal tax concerns are minimizing the amount of interest or original issue discount income on debt issued in the restructuring, the ability to recognize a loss on the exchange, and the allocation of amounts received in the restructuring (whether in the form of new debt or otherwise) between accrued interest and principal on the old debt.

If not handled properly from a tax point of view, the restructuring itself may generate significant tax liability. The tax practitioner's role is therefore to minimize the amount of tax liability that may arise in the restructuring and to optimize the tax efficiency of the restructured company on a going-forward basis.ⁿ¹ Often this requires a balancing and tradeoff between conflicting objectives. The challenge for the practitioner is to reconcile the conflicting tax objectives of the various constituencies within the framework of the other business and corporate goals of the restructuring.

Other miscellaneous issues that might affect the troubled company will also be discussed in this chapter. These include the state tax considerations involved in the issuance of debt by a holding company rather than an operating company, and the ability of the troubled company to continue to accrue interest deductions during the bankruptcy or insolvency period.

This chapter will focus on the tax consequences of corporate debt restructurings. Special considerations may apply in restructuring the debt of a non-corporate entity or a Subchapter S Corporation.ⁿ²

FOOTNOTES:

(n1)Footnote 1. For additional discussions of the tax issues that may arise in a restructuring, *see generally Collier on Bankruptcy Taxation* (Matthew Bender 2007); G. Henderson & S. Goldring, *Tax Planning for Troubled Corporations: Bankruptcy and Nonbankruptcy Restructurings* (CCH 2009).

(n2)Footnote 2. See, e.g., R. Lipton, *The Story of the Tortoise and the Hare: Workouts Involving S Corporations*, 72 Taxes 163 (1994); R. Lipton, *Planning for Noncorporate Debt Workouts Outside of Bankruptcy*, 70 Taxes 275 (1992); R. Lipton, *Tax Planning for Noncorporate Bankruptcies*, 70 Taxes 653 (1992).



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P 8.02 Measuring Debt Discharge and Original Issue Discount.

[1] Background.

In *United States v. Kirby Lumber*,ⁿ¹ the Supreme Court held that a debtor recognizes taxable income upon the satisfaction of its indebtedness for less than the face amount of the indebtedness. This principle was codified in *section 61(a)(12) of the Internal Revenue Code*ⁿ² and is based on the view that forgiveness of debt or satisfaction of a liability at less than face amount enriches the debtor and should therefore be treated as gross income. As discussed further below, this rule has been temporarily modified by new section 108(i), which allows a troubled company to elect to defer the recognition of COD income in certain cases.

An important tax concept for measuring the COD amounts to be included in gross income is "adjusted issue price." Since the face amount of indebtedness is not always the appropriate measure for tax purposes of the amount of liability outstanding, adjusted issue price serves this purpose. For example, if a corporation issues a zero coupon note for \$560 redeemable for a face amount of \$1,000 in five years, the \$1,000 face amount would not be the appropriate measure of the amount of the outstanding liability (since in effect \$440 of the \$1,000 is interest to be accrued over the five year term). Rather, the appropriate measure of the liability on the issue date would be the issue price, in this case \$560.ⁿ³ The \$440 of original issue discount ("OID") will be deducted by the issuer as interest and included in income by the holder under economic accrual principles.ⁿ⁴ The initial issue price would then be adjusted, so that, as of any date, the adjusted issue price would equal the issue price plus any OID accruals.ⁿ⁵ In effect, the accrued but unpaid interest is treated as if paid and then lent to the issuer at the same interest rate. In the case of the foregoing instrument, for example, the adjusted issue price two years after issuance would be \$706 (\$560 plus \$146 accrued OID). When calculating the amount of COD income, this adjusted issue price would then be used instead of the note's face amount of \$1000.

For the purpose of calculating the amount of COD income to be recognized by a debtor, if the debtor satisfies outstanding indebtedness by issuing a new debt instrument, the debtor is treated as having satisfied the indebtedness with an amount of cash equal to the issue price of the new debt instrument.ⁿ⁶ Thus, in an exchange transaction, if the issue price of the new debt, plus the amount of any cash and the fair market value of any other property transferred to the holder, is less than the adjusted issue price of the old debt instrument, the difference will be COD income to the debtor.ⁿ⁷ An exchange may be accomplished either by an actual exchange of the old debt for new debt, property or stock, or by a deemed exchange which takes place when the terms of an indebtedness are significantly modified.ⁿ⁸ The

issue price of any debt instrument issued in satisfaction of indebtedness is determined under either section 1273 or 1274.ⁿ⁹ With respect to an issuance of debt instruments, if a substantial amount of the debt instruments is issued for money, the issue price of each debt instrument is the first price at which a substantial amount of the debt instruments is sold.ⁿ¹⁰ If a substantial amount of the debt instruments is traded on an established market ("publicly traded"), the issue price of each debt instrument is the fair market value of the debt instrument as of the first date on which a substantial amount of the traded debt instruments is issued.ⁿ¹¹ If neither of the previous rules apply and a substantial portion of the debt instruments is issued for publicly traded property, the issue price of each debt instrument is the fair market value of the property as of the first date on which a substantial amount of the debt instruments is issued for publicly traded property.ⁿ¹² For purposes of determining the issue price of a debt instrument, sales by an issuer to underwriters or similar parties are ignored.ⁿ¹³ This rule is generally intended to provide similar treatment for an issuer that compensates its underwriters directly and for one that compensates its underwriters by selling them debt instruments at a discount to face value.

A different rule applies if neither the new debt instrument nor the property acquired in exchange for it is publicly traded, and the new debt instrument is not issued for money. In that case, the issue price of the new debt instrument is determined under section 1274 and is ordinarily its stated principal amount, provided the new debt instrument has "adequate stated interest."ⁿ¹⁴ An instrument has adequate stated interest if its yield to maturity (determined by reference to its stated principal amount) is at least equal to the applicable federal rate ("AFR"), a rate published monthly by the Internal Revenue Service ("Service") and based upon U.S. Treasury ("Treasury") yields for obligations of comparable maturity.ⁿ¹⁵ If the debt instrument does not have adequate stated interest, the issue price is the "imputed principal amount"--which is determined by discounting by the AFR all payments (including interest) scheduled to be made under the debt instrument.ⁿ¹⁶ Thus, when section 1274 applies to a debt instrument without adequate stated interest, it results in an issue price that is less than the stated principal amount, with the difference being treated as OID.

[2] Measurement of COD.

When a troubled company issues new debt for its outstanding debt, significantly different tax consequences can result depending upon whether or not the exchange involves publicly traded securities.ⁿ¹⁷ For example, if a substantial amount of an issue of corporate debt instruments are publicly traded, and a debt instrument in that issue with an adjusted issue price of \$950 and a fair market value of \$700 is exchanged for a newly-issued ten year corporate debt instrument with a face amount of \$1000 and bearing 8% interest, payable semiannually, the issue price of the new debt will be \$700 with the result that the corporation will have \$250 of COD income currently and \$300 of OID deductions over the life of the new debt issue. By contrast, if the foregoing example does not involve publicly traded securities, the issue price of the new debt instrument will be \$1,000 so long as the AFR is 8% or less. Even if the AFR is higher than 8%, less COD income will likely be recognized in an exchange of non-publicly traded securities than in an exchange of publicly traded securities. For example, if the AFR is 9%, the imputed principal amount of the new debt will be \$935, resulting in \$15 of current COD income and \$65 of OID deductions.

It should usually be possible to structure an exchange of non-publicly traded securities to trigger less COD income than an exchange involving publicly traded securities with otherwise identical payment terms. This is because the AFR is a measure of the borrowing cost of the most creditworthy debtor, the U.S. government, and should therefore always be less than the yield demanded by the market from any other issuer. Accordingly, the fair market value of any debt obligation (which would be its issue price if it were publicly traded) should always be less than its imputed principal amount under section 1274 (which would be the highest issue price attainable under section 1274). In debt exchanges involving troubled companies, the resulting difference in the amounts of both COD income and OID deductions will be significant.

The definition of "publicly traded" for U.S. federal income tax purposes is extremely broad and includes, among other things, property that appears on a "system of general circulation" that provides a reasonable basis to determine fair market value by disseminating either recent price quotations or actual prices of recent sales transactions.ⁿ¹⁸ The

increasing variety of electronic trading platforms has exposed ambiguities in the meaning of a "system of general circulation."ⁿ¹⁹ For example, is a system only available to certain buyers a system of "general" circulation? Do "indicative" price quotes qualify as "quotations," if in practice indicative quotes give a reasonable basis for determining fair market value? How big must the lot size of a transaction be so that it provides a reasonable basis to determine fair market value? The definition of "publicly traded" is likely sufficiently broad to possibly include electronic platforms such as Bloomberg and TRACE. In light of these ambiguities, advisors should consider the possibility that any debt instrument, including even secured bank debt, might be publicly traded.

[3] Original Issue Discount.

Debt has OID to the extent the stated redemption price at maturity of the debt exceeds the issue price of the debt.ⁿ²⁰ OID ordinarily is deductible as interest by the issuer and includible as income by the holder under economic accrual principles.ⁿ²¹

Section 163(e)(5) limits the deductibility of OID on certain high yield discount obligations, although the debt holder is still required to include the OID in income, and entitles a corporate debt holder to a partially offsetting dividends received deduction. This provision reflects the fact that high-yield OID instruments sometimes blur the line between debt and equity. If an instrument is covered by this provision, (i) OID is deductible when it is paid, rather than on the usual economic accrual basis, and (ii) interest in excess of the AFR plus 6 percentage points is non-deductible.ⁿ²²

Section 163(e)(5) applies to debt instruments, referred to as "applicable high yield discount obligations" ("AHYDOs"), that when issued have (i) a term greater than 5 years, (ii) a yield to maturity that equals or exceeds the AFR for the month of issuance plus 5 percentage points (the "AHYDO trigger rate"), and (iii) "significant original issue discount."ⁿ²³ Generally, an instrument has significant original issue discount if the cumulative accrued but unpaid OID for any accrual period ending after the fifth anniversary of the issue date exceeds the product of the instrument's issue price and yield to maturity.ⁿ²⁴ In essence, the provision restricts the accrual of more than one year's non-cash interest beyond the first 5 years of the life of a high yield obligation.

The AHYDO rules may have a significant effect on a debt-for-debt exchange in connection with a restructuring if either the old or new debt is publicly traded and, as a result, the issue price of the new instrument is its fair market value. Since indebtedness of a troubled company undergoing a restructuring usually trades at a significant discount from its stated principal amount, the new debt will often have significant OID and a yield to maturity in excess of the AHYDO trigger rate. In contrast, in debt-for-debt exchanges involving non-publicly traded debt, the AHYDO rules usually can be avoided because the corporation and its creditors both will have an incentive to create new debt bearing a stated interest rate that is at least equal to the AFR--which will result in the new debt having an issue price equal to its stated principal amount--but below the AHYDO trigger rate.

As discussed further below, recent changes to the AHYDO rules have provided temporary relief with respect to OID arising as a result of certain debt exchanges.

[4] Exchange of Property for Debt.

If a company exchanges property (other than its own new indebtedness)ⁿ²⁵ for its outstanding indebtedness, the amount of COD income and gain or loss the company will recognize depends upon whether the outstanding indebtedness is recourse or nonrecourse. If the indebtedness is recourse indebtedness, the tax consequences to the company are the same as if the company sold the property for its fair market value and discharged the indebtedness with the proceeds resulting from the sale.ⁿ²⁶ If the company's indebtedness is nonrecourse, the company will be treated as if it sold the property for an amount equal to the outstanding amount of the indebtedness with no COD consequences.ⁿ²⁷ In either case, the

aggregate amount of income recognized is the same, since merely the mix between COD income and gain or loss on the disposition of the property is affected. For this reason, it is often advantageous for the debt to be recourse, since the COD income may qualify for non-taxable treatment.ⁿ²⁸

For example, if a corporation exchanges outstanding indebtedness of \$1,000 and a fair market value of \$400 for property with a fair market value of \$400 and a basis of \$200, the company will recognize \$600 of COD income (\$1,000 - \$400) and \$200 of gain (\$400 - \$200) if the indebtedness is recourse. However, if the indebtedness is non-recourse, the company will have no COD income and will recognize \$800 of gain (\$1,000 - \$200) on the exchange.

FOOTNOTES:

(n1)Footnote 1. *284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 (1931)* .

(n2)Footnote 2. Unless otherwise indicated, section references in this chapter are to the Internal Revenue Code of 1986, as amended ("I.R.C."), *26 U.S.C. § 1, et seq.*

(n3)Footnote 3. The issue price of a debt instrument is initially determined under Section 1273 or 1274. Issue price is then adjusted under Section 1272.

(n4)Footnote 4. *I.R.C. §§ 163(e), 1272*. For an analysis of certain limitations on the deduction of OID, *see P 8.02[3] infra*.

(n5)Footnote 5. *I.R.C. § 1272(a)(4)*.

(n6)Footnote 6. *I.R.C. § 108(e)(10)(A)*.

(n7)Footnote 7. *I.R.C. § 108(e)(10)(A); Treas. Reg. § 1.61-12(c)(2)(ii)*.

(n8)Footnote 8. *Treas. Reg. § 1.1001-1(a)*. For treatment of "significant" modifications that constitute deemed exchanges, *see Treas. Reg. § 1.1001-3(b)*.

(n9)Footnote 9. *I.R.C. § 108(e)(10)(B)*.

(n10)Footnote 10. *Treas. Reg. § 1.1273-2(a)(1)*.

(n11)Footnote 11. *Treas. Reg. § 1.1273-2(b)(1)*. For a discussion of what constitutes trading on an established market, *see 8.02[2] infra* .

(n12)Footnote 12. *I.R.C. § 1273(b)(3)(B)(i); Treas. Reg. § 1.1273-2(c)*.

(n13)Footnote 13. *Treas. Reg. § 1.1273-2(e)*.

(n14)Footnote 14. *I.R.C. § 1274(a)(1)*.

(n15)Footnote 15. *See I.R.C. § 1274(c)(2), (d); Treas. Reg. § 1.1274-4*.

(n16)Footnote 16. *See I.R.C. § 1274(a)(2), (b)*.

(n17)Footnote 17. *See I.R.C. § 1273(b)*.

(n18)Footnote 18. *Treas. Reg. § 1.1273-2(f)(4)*. Property will also be treated as publicly traded if, within the 60-day period ending 30 days after the issue date: (i) the property is listed on a registered national securities exchange, an interdealer quotation system sponsored by a registered national securities association or on certain foreign exchanges or boards of trade; (ii) it is traded on a board of trade that is designated as a contract market by the Commodity Futures

Trading Commission or on an interbank market; or (iii) price quotations are readily available from dealers, brokers or traders. *Treas. Reg. §§ 1.1273-2(f)(1)-(3)*, (5).

(n19)Footnote 19. See New York State Bar Ass'n Tax Section, *Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273*, Tax Analysts Doc. 2004-16626 (Aug. 12, 2004).

(n20)Footnote 20. *I.R.C. § 1273(a)(1)*. For a more detailed discussion of the OID rules, see D. Garlock, *Federal Income Taxation of Debt Instruments* (CCH 5th ed. 2005 & Supp. 2009). Special rules beyond the scope of this chapter apply to contingent payment and variable rate debt instruments. For a discussion of these topics, see *id.* chs. 8 & 9.

(n21)Footnote 21. *I.R.C. § 163(e)(1)* (issuer's deduction); *I.R.C. § 1272(a)(1)* (holder's inclusion).

(n22)Footnote 22. See *I.R.C. § 163(e)(5)*. For a thorough discussion of the AHYDO rules and planning options, see M. Ginsburg & J. Levin, *Mergers, Acquisitions, and Buyouts* § 1303 (Aspen Publishers 2008).

(n23)Footnote 23. *I.R.C. § 163(i)(1)*.

(n24)Footnote 24. *I.R.C. § 163(i)(2)*.

(n25)Footnote 25. If the property used to satisfy the debt is stock of the debtor corporation, for purposes of computing COD income the corporation is treated as having satisfied the debt with an amount of money equal to the fair market value of the stock. *I.R.C. § 108(e)(8)*.

(n26)Footnote 26. See *Treas. Reg. § 1.1001-2(a)(2)*, (c) (example 8). See also *Gehl v. Comm'r*, 102 T.C. 784 (1994), *aff'd*, 95-1 U.S. Tax Cas. (CCH) P 50,191 (8th Cir. 1995); *Rev. Rul. 90-16*, 1990-1 C.B. 12.

(n27)Footnote 27. See *Treas. Reg. § 1.1001-2(a)(1)*, (c) (example 7); *cf. Comm'r v. Tufts*, 461 U.S. 300, 103 S. Ct. 1826, 75 L. Ed. 2d 863 (1983).

(n28)Footnote 28. See P 8.03 *infra*.



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P 8.03 Special Exceptions and Rules Relating to COD.

[1] Bankruptcy/Insolvency.

As indicated above, section 61(a)(12) requires the inclusion of COD income in gross income. *Internal Revenue Code section 108(a)(1)(B)* codifies long-standing judicial precedent that a taxpayer does not recognize COD income to the extent it is insolvent.ⁿ¹ Any debt discharge in excess of the amount by which the taxpayer is insolvent will result in recognition of COD income unless the taxpayer is in a title 11 proceeding.ⁿ² If a taxpayer is in a title 11 proceeding, its debt discharge is totally excluded from income without regard to its solvency.ⁿ³

A taxpayer is "insolvent" if its liabilities exceed the fair market value of its assets, including assets not on the balance sheet such as goodwill and other intangibles.ⁿ⁴ Pursuant to case law predating the enactment of section 108(a)(1)(B), assets exempt from creditors' claims under applicable state law were excluded from the insolvency determination.ⁿ⁵ However, the Service has taken the position that the exclusion applied only to the judicial insolvency exception and was overruled by the enactment of section 108(a)(1)(B).ⁿ⁶ In a recent decision, the Tax Court has agreed with the Service's position that the insolvency calculation does not exclude assets exempt from creditors' claims.ⁿ⁷ The fair market value of the assets is determined on a going-concern basis.ⁿ⁸ It is unclear whether breakup value should be taken into account.ⁿ⁹ Liabilities are presumably valued at adjusted issue price regardless of market or credit discounts. It is unclear to what extent contingent liabilities may be taken into account in determining insolvency. In appropriate cases, however, a reasonable reserve should be included for contingent liabilities.ⁿ¹⁰ It is also unclear whether the potential tax liability resulting from the discharge of indebtedness or the expenses of the reorganization should be included in the taxpayer's liabilities. The method by which a consolidated group's solvency is to be determined is also uncertain. The better view is that insolvency is determined on a separate company basis.ⁿ¹¹ The taxpayer's solvency is to be determined immediately before the debt discharge.ⁿ¹² Thus, assets must be valued and liabilities determined before the debt discharge since COD income is avoided only to the extent of insolvency at that time.

Taxpayers that exclude COD income from taxable income because they are either insolvent or in a title 11 proceeding must apply the amount excluded to reduce their tax attributes in the following order: (1) NOLs; (2) general business credit carryovers (\$0.33 for each dollar of income excluded); (3) minimum tax credits (\$0.33 for each dollar of income excluded); (4) capital loss carryovers; (5) basis of depreciable and non-depreciable assets (pursuant to ordering rules contained in *Treasury regulation 1.1017-1(a)*); (6) passive activity loss and credit carryovers (with respect to credit carryovers, \$0.33 for each dollar of income excluded); and (7) foreign tax credit carryovers (\$0.33 for each dollar of

income excluded).ⁿ¹³ Alternatively, a taxpayer may elect to reduce the basis of its depreciable property by any portion of the excluded COD income.ⁿ¹⁴ Certain additional rules apply when the election is made.ⁿ¹⁵ COD income that is excluded from taxable income in excess of the amount of tax attributes required to be reduced is permanently excluded from the taxpayer's gross income.ⁿ¹⁶

Tax attributes are reduced after the determination of tax for the taxable year of discharge.ⁿ¹⁷ Thus, a taxpayer may use its existing NOLs to shelter operating income (or COD income in excess of insolvency) arising in the year of discharge before any remaining NOLs are reduced under the attribute reduction rules. For example, if an insolvent corporation with an NOL carryover of \$1 million has \$1 million each of operating income and COD income (excludable under the insolvency exception), the NOL is fully available to shelter the operating income without reduction on account of the COD exclusion. The recent taxpayer can carry back NOLs and other tax attributes to tax years preceding the year of discharge before the remaining attributes are reduced on account of COD income.ⁿ¹⁸

In the case of debtors who are members of a consolidated group, the regulations generally take a consolidated approach to NOL reduction. Somewhat controversial is a "look through" rule for basis reduction, which can result in lower-tier subsidiaries of the debtor having to reduce their basis in assets. The regulations provide for attribute reduction with respect to any loss that is part of the consolidated NOL or the separate company NOL of the discharged debtor. While the regulations provide that the entire consolidated NOL is available for attribute reduction, they also provide fairly detailed rules concerning the ordering of NOL reduction.ⁿ¹⁹

The regulations generally require a look through to the attributes of a subsidiary for attribute reduction purposes to the extent the debtor's basis in the stock of the subsidiary was reduced as a result of the debtor's attribute reduction.ⁿ²⁰

If the debtor corporation elects to reduce the basis of its depreciable property under section 108(b)(5), the stock of consolidated subsidiaries held by such corporation is treated as a depreciable asset to the extent that such subsidiaries consent to a corresponding reduction in the basis of their depreciable property.ⁿ²¹ In addition, as discussed above, in some cases the new consolidated return regulations impose mandatory reductions in the asset basis of a consolidated subsidiary of the debtor, even in the absence of a section 108(b)(5) election.

Even if a consolidated group manages to avoid some or all attribute reduction under section 108, this lack of attribute reduction may trigger into income an excess loss account ("ELA") of a group member in the stock of its debtor subsidiary.ⁿ²² In some cases, it may be possible to eliminate an ELA in the stock of a debtor member of the group prior to triggering COD income.

[2] Acquisition of Debt by a Related Person.

Section 108(e)(4) provides that, to the extent provided in regulations, if a person related to a debtor corporation, such as a 50 percent or greater shareholder, or if a person who has become related to the debtor corporation on the date that debt is acquired, acquires the corporation's debt from a person unrelated to the debtor corporation, this "direct acquisition" will be treated as having been made by the debtor corporation.ⁿ²³ Accordingly, debt discharge may arise even if the corporation's debt remains outstanding.

Regulations apply this rule to "indirect acquisitions" as well.ⁿ²⁴ An indirect acquisition is a transaction in which a holder of an indebtedness becomes related to the debtor if the holder acquired the indebtedness in anticipation of becoming related to the debtor.ⁿ²⁵ A holder is treated as acquiring debt in anticipation of becoming related to the debtor if the holder acquires the debt less than 6 months before becoming related to the debtor.ⁿ²⁶

Indebtedness acquired 6 months or more prior to the date on which a holder becomes related to the debtor is treated as acquired in anticipation of becoming related to the debtor on the basis of a facts-and-circumstances determination. Under the regulation, such facts and circumstances include, but are not limited to:

- (i) the intent of the parties at the time of the acquisition;
- (ii) the nature of any contacts between the parties;
- (iii) the period of time the holder held the indebtedness; and
- (iv) the significance of the indebtedness in proportion to the total assets of the holder group.ⁿ²⁷ A holder is required to attach a disclosure statement to its tax return if, on the date the holder becomes related to the debtor, the indebtedness of the debtor represents more than 25% of the fair market value of the total gross assetsⁿ²⁸ of the holder group, or if the holder acquires the indebtedness at least 6 months, but less than 24 months, before the holder becomes related to the debtor.ⁿ²⁹ If a holder fails to provide that statement, the holder is presumed to have acquired the indebtedness in anticipation of becoming related to the debtor unless the facts and circumstances clearly establish the contrary.ⁿ³⁰

The amount of COD income in direct and indirect acquisitions is generally equivalent to the difference between the adjusted issue price of the acquired debt and its adjusted basis.ⁿ³¹ Accordingly, the debtor corporation will recognize the same amount of COD income in both an indirect and a direct acquisition. However, if the indebtedness is acquired more than 6 months prior to the date on which the holder becomes related to the debtor ("acquisition date"), the amount of COD income is equivalent to the difference between the adjusted issue price of the old indebtedness on the acquisition date and its fair market value.ⁿ³²

If a corporation realizes COD income (whether or not excludible on account of bankruptcy or insolvency) as a result of a related party acquisition, the indebtedness so acquired is treated as new indebtedness issued by the debtor to the related party holder on the acquisition date.ⁿ³³ The "new debt" has an issue price equal to the amount assigned to the new debt in computing the amount of COD income realized on the related party acquisition, and has OID equal to the difference between its stated redemption price at maturity and the issue price so determined.ⁿ³⁴

A related party holder does not recognize any gain or loss on the deemed issuance of the "new debt." However, the deemed issuance is treated as a purchase of the indebtedness by the related party for purposes of sections 1272(a)(7) and 1276.ⁿ³⁵ If the related party holder acquires the debtor's indebtedness in exchange for its own indebtedness and the issue price of the related party holder's indebtedness was not determined by reference to its fair market value (*e.g.*, if it was determined pursuant to section 1274), then any loss on any subsequent disposition of the indebtedness is deferred until the debtor retires the indebtedness.ⁿ³⁶

The related party acquisition rule does not apply to indebtedness (i) with a stated maturity equal to or less than one year after the acquisition date and that is actually retired on or before the maturity date, or (ii) to certain acquisitions by securities dealers.ⁿ³⁷

[3] Miscellaneous Exceptions From the Creation of Income From Debt Discharge.

Section 108(e)(2) of the Internal Revenue Code provides that no income from the discharge of indebtedness is realized to the extent that payment of the liability would have given rise to a deduction. This primarily applies to issuers on the cash method of accounting.

Section 108(e)(5), applicable only to solvent debtors, provides that if a seller of property reduces the debt of a purchaser that arose out of the purchase of the property, the reduction will be treated by the purchaser and seller as a purchase price adjustment on the sale of that property, not as COD income. The legislative history suggests that the section 108(e)(5) exception does not apply if the original purchaser has transferred the property or the seller has transferred the debt.ⁿ³⁸ However, when the transfer and assumption occur in connection with a nonrecognition transaction, a 1990

private letter ruling suggests that the Service will permit the transferee to be treated as the purchaser for purposes of section 108(e)(5).ⁿ³⁹ In addition, section 108(e)(5) generally does not apply to third-party financing.ⁿ⁴⁰

If a shareholder contributes a corporation's indebtedness to that corporation as a capital contribution, the corporation is treated as satisfying the indebtedness with an amount of money equal to the shareholder's adjusted basis in the indebtedness.ⁿ⁴¹ Accordingly, in this situation, the corporation recognizes COD income only to the extent the adjusted issue price of the indebtedness exceeds the shareholder's adjusted basis.ⁿ⁴² This exception only applies if the shareholder contributes the debt in its capacity as a shareholder.ⁿ⁴³

[4] Temporary Relief from COD and AHYDO Rules

[a] Hung Bridge Loans

As a result of the recent precipitous decline in credit market conditions, many underwriters that had entered into financing commitments prior to the crisis found themselves unable to resell newly issued debt instruments to the public because the economic terms of the debt were no longer attractive to the market. Such underwriters were forced to either hold onto the debt as principals or "unload" it into the market at a loss. The issue price of an issue of debt sold by an underwriter is unaffected by the price paid by the underwriter to the issuer and instead is determined by the sale price to the public, as discussed above in paragraph 8.02[1]. Therefore, sales of the debt by an underwriter at a significant discount to principal amount may render an issue an AHYDO, even if the issuer has received the full principal amount in cash from the underwriter.

In Revenue Procedure 2008-51,ⁿ⁴⁴ the Service granted temporary relief from the application of the AHYDO rules to debt instruments issued by a corporation to a lender that either (i) are sold by the lenders to third parties at a significant discount to the cash proceeds provided to the issuer or (ii) are modified before they are sold by the lenders to third parties. Under the Revenue Procedure, a debt instrument issued on or after August 8, 2008 pursuant to a financing commitment obtained before January 1, 2009 will not be an AHYDO so long as it would not have been an AHYDO if its issue price were equal to the "net cash proceeds" actually received by the corporation for the debt instrument.ⁿ⁴⁵

Although this Revenue Procedure grants a reprieve from the application of the AHYDO rules, it does not prevent recognition of COD income upon an exchange or deemed exchange of an eligible debt instrument.ⁿ⁴⁶

[b] Deferral of COD Income

The American Recovery and Reinvestment Act of 2009ⁿ⁴⁷ added section 108(i)(1) to the Code, providing an election to defer COD income recognized in 2009 and 2010 from the repurchase or modification of a corporation's outstanding debt and to include such income ratably over a five taxable-year period generally beginning in 2014.

OID deductions on a new debt instrument issued in exchange for the outstanding debt instrument that do not exceed the amount of COD income deferred are deducted from income during the period over which the COD income is included.ⁿ⁴⁸ An issuer is therefore prevented from taking advantage of early deductions while deferring the offsetting income. Assuming the principal amount of the new debt is the same as that of the old debt, the COD income should be fully offset by the new OID deductions.

[c] AHYDO Relief

The Act also added section 163(e)(5)(F), which suspends the AHYDO rules with respect to any debt instrument issued between September 1, 2008 and December 31, 2009 in exchange or in a deemed exchange for a debt instrument that was issued by the same issuer and that is not subject to the AHYDO rules, either because of pre-existing law or because of new section 163(e)(5)(F).

Section 163(i)(1)(ii) of the Act grants the Secretary the power to permit an interest rate different than the AFR to be used for purposes of determining if a debt instrument issued after December 31, 2009 is subject to the AHYDO rules, if such a rate is "appropriate in light of distressed conditions in the debt capital markets." In other words, Treasury will have the discretion to modify the AHYDO trigger rate, to reflect the fact that in current financial crisis conditions an interest rate that merely exceeds AFR by 5% may not be a good indicator of the equity-like nature of a debt instrument.

FOOTNOTES:

(n1)Footnote 1. *Dallas Transfer & Terminal Warehouse Co. v. Comm'r*, 70 F.2d 95 (5th Cir. 1934) ; *Lakeland Grocery Co. v. Comm'r*, 36 B.T.A. 289 (1937) .

(n2)Footnote 2. *See I.R.C. §§ 108(a)(2)(A), (3).*

(n3)Footnote 3. *I.R.C. § 108(a)(1)(A).*

(n4)Footnote 4. *See Conestoga Transp. Co. v. Comm'r*, 17 T.C. 506 (1951) , *acq.*, 1952-1 C.B. 2 . This was also the position taken by the Service in *J.A. Maurer, Inc. v. Comm'r*, 30 T.C. 1273, 1292 (1958) , *acq.*, 1959-2 C.B. 5 . The term "insolvent" may have a different meaning for non-tax purposes. *See P 3.05[2] supra.*

(n5)Footnote 5. *See Hunt v. Comm'r*, 57 T.C.M. (CCH) 919, 946 (1989) ; *Davis v. Comm'r*, 69 T.C. 814, 833 (1978) ; *Cole v. Comm'r*, 42 B.T.A. 1110, 1113 (1940) , *nonacq.*, 1941-1 C.B. 13 ; Tech. Adv. Mem. 91-30-005 (Mar. 29, 1991) ; Priv. Ltr. Rul. 91-25-010 (Mar. 19, 1991) .

(n6)Footnote 6. *See Priv. Ltr. Rul.* 1999-32-013 (May 4, 1999), revoking Priv. Ltr. Rul. 91-25-210 (Mar. 19, 1991) ; *see also* Tech. Adv. Mem. 1999-35002 (May 3, 1999) , revoking Tech. Adv. Mem. 91-30-005 (March 29, 1991) .

(n7)Footnote 7. *See Carlson v. Comm'r*, 116 T.C. 87 (2001) ; *see also Gitlitz v. Comm'r*, 531 U.S. 206, 215, 121 S. Ct. 701, 707, 148 L. Ed. 2d 613, 623 (2001) (stating that "Section 108(e) precludes us from relying on any understanding of the judicial insolvency exception that was not codified in § 108.").

(n8)Footnote 8. *See Conestoga*, n.4 *supra*, 17 T.C. 506, 513 ; *see also In re Ohio Corrugating Co.*, 91 B.R. 430 (Bankr. N.D. Ohio 1988) .

(n9)Footnote 9. *See Estate of Newhouse v. Comm'r*, 94 T.C. 193, 237-40, 242 (1990) , *nonacq.*, 1991-2 C.B. 1 .

(n10)Footnote 10. *See Conestoga*, n.4 *supra* (in which going concern value and reserves for contingencies were taken into account in determining insolvency); *J.A. Maurer*, n.4 *supra*. *But see* Priv. Ltr. Rul. 83-48-001 (Aug. 18, 1983) (Issue 6); *Merkel v. Comm'r*, 109 T.C. 463 (1997) , *aff'd*, 192 F.3d 844 (9th Cir. 1999) (insolvency calculation should only include a liability if "it is more likely than not" that the taxpayer will be called upon to pay it in the amount claimed).

(n11)Footnote 11. *See, e.g., Wyman-Gordon Co. v. Comm'r*, 89 T.C. 207, 221-24 (1987) (*I.R.C. § 108* applied on a separate company basis).

(n12)Footnote 12. *I.R.C. § 108(d)(3).*

(n13)Footnote 13. *I.R.C. §§ 108(b)(2) and (3).*

(n14)Footnote 14. *I.R.C. § 108(b)(5)*. Basis reduction under *I.R.C. § 108(b)(2)* is limited to the amount by which the tax basis of property held immediately after the cancellation exceeds liabilities remaining at that time. *I.R.C. § 1017(b)(2)*. In contrast, no such limitation applies if section 108(b)(5) treatment is elected. *I.R.C. § 1017(b)(2)*.

(n15)Footnote 15. *See, e.g., I.R.C. §§ 1017(b)(2) and (3).*

(n16)Footnote 16. See *Treas. Reg. § 1.108-7(a)(2)*; S. Rep. No. 96-1035, at 13 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n17)Footnote 17. *I.R.C. § 108(b)(4)(A)*.

(n18)Footnote 18. *Treas. Reg. § 1.108-7(b)*.

(n19)Footnote 19. See *Treas. Reg. § 1.1502-28*.

(n20)Footnote 20. See *Treas. Reg. § 1.1502-28(a)(3)*.

(n21)Footnote 21. *I.R.C. § 1017(b)(3)(D)*. See, e.g., Priv. Ltr. Rul. 96-50-019 (Sept. 11, 1996) (an excess loss account is created to the extent a consolidated subsidiary consents to a reduction in the basis of its assets in excess of the parent corporation's basis in the subsidiary's stock).

(n22)Footnote 22. See *Treas. Reg. § 1.1502-19(c)(1)(iii)(B)*.

(n23)Footnote 23. See *I.R.C. § 108(e)(4)(A)* (providing that whether the debtor is related to the original creditor or the new creditor is determined under *I.R.C. § 267(b)* and *§ 707(b)(1)*). The Service is authorized to provide guidance that certain direct acquisitions will not be treated as direct acquisitions for purposes of *I.R.C. § 108(e)(4)*. *Treas. Reg. § 1.108-2(b)*.

(n24)Footnote 24. *Treas. Reg. § 1.108-2(c)*.

(n25)Footnote 25. *Treas. Reg. § 1.108-2(c)(1)*.

(n26)Footnote 26. *Treas. Reg. § 1.108-2(c)(3)*.

(n27)Footnote 27. *Treas. Reg. § 1.108-2(c)(2)*. "Holder group" means the holder of the indebtedness and all persons who are both related to the holder before and related to the debtor after the date the holder becomes related to the debtor. *Treas. Reg. § 1.108-2(c)(5)*.

(n28)Footnote 28. Total gross assets do not include any cash, cash item, marketable stock or security, short-term indebtedness, option or futures contract, notional principal contract, or any similar item (other than indebtedness of the debtor). *Treas. Reg. § 1.108-2(c)(4)(ii)(B)*.

(n29)Footnote 29. *Treas. Reg. § 1.108-2(c)(4)(iii)*.

(n30)Footnote 30. *Treas. Reg. § 1.108-2(c)(4)(v)*.

(n31)Footnote 31. *Treas. Reg. § 1.108-2(f)(1)*.

(n32)Footnote 32. *Treas. Reg. § 1.108-2(f)(2)*.

(n33)Footnote 33. *Treas. Reg. § 1.108-2(g)(1)*.

(n34)Footnote 34. *Treas. Reg. § 1.108-2(g)(1)*.

(n35)Footnote 35. *Treas. Reg. § 1.108-2(g)(2)*.

(n36)Footnote 36. *Treas. Reg. § 1.108-2(g)(3)*.

(n37)Footnote 37. *Treas. Reg. §§ 1.108-2(e)(1), (2)*.

(n38)Footnote 38. See S. Rep. No. 96-1035, at 16 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); H.R. Rep. No. 96-833, at 13 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised).

(n39)Footnote 39. Priv. Ltr. Rul. 90-37-033 (June 18, 1990) . For a discussion of the ruling and the purchase price exception, see L. Weindruch & D. Brown, *Scope of Purchase Price Exception to COD Income Questioned in New Ruling*, 74 J. Tax'n 302 (1991).

(n40)Footnote 40. See *Preslar v. Comm'r*, 167 F.3d 1323, 1331-33 (10th Cir. 1999) ; *Rev. Rul. 92-99, 1992-2 C.B. 35* . One exception to this rule may arise if the third-party debt reduction "is based on an infirmity that clearly relates back to the original sale." *Rev. Rul. 92-99, 1992-2 C.B. 35* .

(n41)Footnote 41. *I.R.C. § 108(e)(6)*.

(n42)Footnote 42. In Field Service Advice 1999-15-005 (Dec. 17, 1998), the Service suggested that this exception from COD income applies only to the extent that the shareholder's debt forgiveness made the corporation solvent. The remaining debt forgiveness, according to the Service, could not be a capital contribution eligible for section 108(e)(6), and therefore triggered COD. See also Priv. Ltr. Rul. 2005-37-026 (June 17, 2005) (contributions of intercompany loans to the capital of subsidiary by its corporate parents were only partially covered by section 108(e)(6)).

(n43)Footnote 43. Legislative history indicates that a shareholder that is also a creditor is not viewed as contributing the debt in its capacity as a shareholder if it acts merely as a creditor attempting to maximize the satisfaction of a claim. See S. Rep. No. 96-1035, 96th Cong., 2d. Sess. 19 n.22 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); 15 *Collier on Bankruptcy*, P TX6.03[5][a] (Matthew Bender 15th Ed. Revised).

(n44)Footnote 44. *2008-35 I.R.B. 562* (Aug. 8, 2008) .

(n45)Footnote 45. *Rev. Proc. 2008-51* also provides relief for debt instruments issued in exchange or in deemed exchange for debt instruments to which it applies in the first instance.

(n46)Footnote 46. For a complete discussion of *Rev. Proc. 2008-51* and related issues, see New York State Bar Association Tax Section, *Report on Revenue Procedure 2008-51* (Jan. 20, 2009) (*available at* TaxCore IRS Documents (Jan. 22, 2009)).

(n47)Footnote 47. Pub. L. No. 111-5.

(n48)Footnote 48. *I.R.C. § 108(i)(2)*.



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Collier Business Workout Guide

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CHAPTER 8 Tax Aspects of Workouts

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P 8.04 Utilizing NOLs to Reduce COD Income.

[1] Overview.

NOLs are the excess of deductions over gross income for a taxable year. NOLs for a taxable year generally can be carried back to the two taxable years preceding the year of the loss and carried forward to the 20 taxable years following the taxable year of the loss.ⁿ¹ In considering the effect of COD income on the troubled company, NOLs are an important factor since they may shelter this income from tax. Moreover, the preservation of any NOLs not absorbed by COD income for use by the company after restructuring is a significant consideration in any recapitalization transaction because it increases the after-tax cash flow of the restructured company.ⁿ²

[2] Section 382.

Section 382 provides in general that after the date on which a corporation's ownership has changed (referred to as an "ownership change"), the amount of taxable income against which its pre-change NOLs and certain built-in losses may be used in a taxable year will be limited.ⁿ³ The general limit (the "section 382 limitation") is equal to the product of the value of the corporation's stock immediately before the ownership change and the "long-term tax-exempt rate," a rate published monthly by the Service.ⁿ⁴ The rate is based upon prevailing rates for long-term Treasuries, adjusted to reflect differences between rates on long-term taxable and tax-exempt obligations.ⁿ⁵ For example, if an ownership change occurs with respect to a corporation whose aggregate stock value is \$10 million when the long-term tax-exempt interest rate is 5.5%, the corporation generally will not be able to utilize more than \$550,000 per year of its pre-change NOLs after the ownership change. This limit is increased by the amount of certain built-in gains.ⁿ⁶

Subject to the built-in gain rule, the section 382 limitation is zero (*i.e.*, no utilization) after an ownership change if the corporation does not continue its pre-change business enterprise for two years following the ownership change.ⁿ⁷ This requirement is satisfied if the new owners continue at least one significant line of the corporation's historic business or use a significant portion of its historic assets in a new business.ⁿ⁸

The determination of whether an ownership change has occurred is made by determining the percentage point increase in ownership for each 5% shareholder separately and then aggregating the percentage point increases for all 5% shareholders. A 5% shareholder's percentage point increase is measured by reference to the shareholder's lowest percentage ownership during the 3-year testing period.ⁿ⁹ An ownership change occurs if the aggregate percentage point increase is greater than 50%.ⁿ¹⁰ Accordingly, it is possible for control to shift in a non-tax sense, without an

"ownership change" for section 382 purposes, and vice versa. For example, if a shareholder who owned 30% of a corporation for the last 3 years acquires an additional 30%, and no other owner shifts occur, there would be no change of control for section 382 purposes.

Section 382 contains a host of technical rules relating to the determination of whether an ownership change has occurred.ⁿ¹¹ In a workout situation, an ownership change often occurs when the company is recapitalized by the issuance of stock for debt. Special rules are available to corporations in a title 11 or similar proceeding that can preserve NOL utilization through certain types of ownership changes.ⁿ¹²

In certain circumstances an option to acquire stock will be treated as having been exercised for purposes of determining whether an ownership change has occurred.ⁿ¹³ Under the Treasury regulations, an option is deemed to be exercised if both a principal purpose of the issuance, transfer or structuring of the option is to avoid or ameliorate the impact of an ownership change and the option triggers an ownership test, a control test or an income test.ⁿ¹⁴

Whether an option triggers any of the ownership, control or income tests depends on all relevant facts and circumstances, which include a weighing of business purpose, likelihood of exercise of the option, any related transactions and the consequences of treating the option as exercised.ⁿ¹⁵ The regulations list specific factors that apply to each test: the ownership test generally will be triggered if the issuance, transfer or structuring of the option provides the holder of the option with a substantial portion of the attributes of ownership of the underlying stock prior to the exercise of the option;ⁿ¹⁶ the control test generally will be triggered if the holder or a related person have, in the aggregate, a direct and indirect ownership interest in excess of 50 percent;ⁿ¹⁷ and the income test generally will be triggered if the issuance, transfer or structuring of the option facilitates the creation of income or value prior to the exercise of the option.ⁿ¹⁸ Notwithstanding any of the above, an option will not be treated as exercised if a principal purpose of its issuance, transfer or structuring is to avoid an ownership change by having it treated as exercised.ⁿ¹⁹

The regulations also provide several safe harbor situations in which options will not be deemed to be exercised:

- (1) stock purchase agreements with commercially reasonable terms and closing conditions that are closed on a change date within one year of signing (not applicable to the income test);
- (2) escrow, pledge or other security agreements subject to customary commercial conditions;
- (3) certain reasonable compensatory options;
- (4) options exercisable on death, disability, mental incompetency or retirement;
- (5) rights of first refusal with customary terms between shareholders of a corporation and regarding the corporation's shares;
- (6) and any other option specified by the Service.ⁿ²⁰

[3] Closing of the Books.

Section 382 ratably apportions a corporation's income for the year in which an ownership change occurs based upon the number of days in the year before and after the ownership change (the "Ratable Allocation Rule").ⁿ²¹ Because the Ratable Allocation Rule allocates taxable income (but not each component thereof), operating or other losses incurred during the year in which an ownership change occurs can offset income and gains recognized in that year without limitation. In addition, income allocated to the pre-ownership change portion of the year may be offset by existing NOLs without limitation. Accordingly, NOL utilization can be maximized in cases where substantial COD income is created in the restructuring by controlling the date on which the ownership change occurs. In certain situations, it may

be advantageous to opt out of the Ratable Allocation Rule. For example, ratable allocation may prove disadvantageous if the bulk of the loss corporation's income is recognized prior to the date of the ownership change. The treasury regulations allow a loss corporation to make an election to allocate income and losses on the basis of a closing of the taxpayer's books on the change date.ⁿ²² If a closing of the books election is made, only net income or loss will be allocated based on a closing on the change date.

[4] Built-In Gains.

The section 382 limitation is increased by the corporation's recognition of built-in gains within five years after the ownership change occurred (the "recognition period") to the extent the corporation had a "net unrealized built-in gain" prior to the ownership change, and the extent to which the net amount of all recognized built-in gains and built-in losses exceeded the lesser of (i) 15% of the value of the corporation's assets or (ii) \$10,000,000.ⁿ²³ Net unrealized built-in gains are the amount by which the fair market value of assets of the corporation immediately prior to the ownership change is greater than the aggregate adjusted basis of the items at that time.ⁿ²⁴ Built-in gains generally include COD income that is recognized after the ownership change.ⁿ²⁵ Accordingly, the relief from the section 382 limitation provided by built-in gains is often a significant component of tax planning in debt restructurings.ⁿ²⁶

If the net unrealized built-in loss exceeds the *de minimis* threshold, built-in losses recognized within the recognition period are treated as pre-change losses (but only to the extent the aggregate of such recognized losses do not exceed the net unrealized built-in loss) so that their utilization is subject to the section 382 limitation.ⁿ²⁷ Under section 382(h)(6)(B), certain deductions that are allowable during the recognition period but that are attributable to the period before the ownership change will be treated as recognized built-in losses.

[5] Consolidated Groups.

Treasury regulations addressing the application of section 382 in a consolidated group context generally adopt a single entity approach to determining the section 382 limitation and the built-in gain or loss threshold.ⁿ²⁸ The single entity approach to section 382 reflects the principle that losses arising while two or more corporations are members of a consolidated group and that are therefore available to be used among the members should remain so available following an ownership change, subject only to the restrictions that would be imposed on a single entity in similar circumstances.

As a general rule, when the parent of a loss group experiences an ownership change, the section 382 limitation applies to the entire group's pre-change NOLs, and not to each individual member separately.ⁿ²⁹ For purposes of calculating the section 382 limitation, the value of the loss group is generally the total value, immediately before the ownership change, of the stock of each member, determined without regard to stock owned directly or indirectly by another member.ⁿ³⁰ The loss group's net unrealized built-in gain or loss is likewise determined on a consolidated basis by adding the separate net unrealized built-in gains or losses of each member. Similarly, the \$10,000,000 or 15% threshold is applied on a consolidated basis to the sum of the separately computed net unrealized built-in gains or losses.ⁿ³¹ The continuity of business requirement is applied on a single entity basis as well.ⁿ³²

A loss group member that leaves the group after an ownership change has a section 382 limitation of zero (*i.e.*, no NOL utilization). However, the common parent of the loss group may elect to apportion all or part of the group's section 382 limitation to the departing member.ⁿ³³ This election should be considered when purchasing a subsidiary out of a consolidated group or planning a restructuring that would cause a subsidiary to deconsolidate.

The regulations specifically reserve as to the application of the section 382 bankruptcy exception to consolidated groups.ⁿ³⁴ This reservation creates uncertainty in a restructuring of the debt of a holding company with many operating subsidiaries. The focus on ownership of the "loss corporation" (rather than the consolidated group) of the provisions of section 382 dealing with the bankruptcy exception suggests that it is not necessary for the subsidiaries to file bankruptcy petitions in order for the group to avail itself of these rules.ⁿ³⁵

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 172(b)(1)(A)*. The American Recovery and Reinvestment Act of 2009 amended section 172(b) to provide for a special rule relating to the NOLs of electing eligible small businesses for the taxable year ending in 2008 (or for any taxable year beginning in 2008 at the election of the taxpayer) that generally increases the standard 2-year carryback period to a period of not more than 5 years. *I.R.C. § 172(b)(1)(H)*. Also, note that a company may not eliminate its tax liability entirely through NOL deductions. This is so because of the alternative minimum tax ("AMT"). Under the AMT, a company may only offset 90% of its alternative minimum taxable income with NOL deductions. *I.R.C. § 56(d)(1)(A)*. Accordingly, a company may be subject to a 2% effective tax rate (10% of its alternative minimum taxable income multiplied by the 20% AMT tax rate). Finally, under *I.R.C. § 55(e)*, qualifying "small corporations" are not subject to the AMT at all.

(n2)Footnote 2. For a thorough analysis of the provisions limiting the use of NOLs, see Keyes, *Issuance of Stock in Corporate Debt Restructurings: Selected Issues Under Sections 108 and 382*, 51 N.Y.U. Inst. Fed. Tax'n, ch. 25 (Matthew Bender 1993); M. Silverman, *Section 382*, in *Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations and Restructurings* 2006, at 496 (PLI Tax Law & Estate Planning Course Handbook Series No. 733, 2006).

(n3)Footnote 3. Under complex "successor" rules, an acquiror or transferee corporation that inherits the tax attributes or receives the assets of a loss corporation in a tax-free transaction may be treated as the "new" loss corporation for purposes of section 382. See *Treas. Reg. §§ 1.382-2(a)(1)* and (5); Chief Counsel Advice 2002-38-025 (June 14, 2002) (U.S. corporation that purchased a foreign target with a built-in loss in its assets, and "checked the box" to treat the target corporation as a disregarded entity, was a "successor" of target and subject to section 382 with respect to the built-in loss).

(n4)Footnote 4. *I.R.C. § 382(b)(1)*.

(n5)Footnote 5. *I.R.C. § 382(f)*.

(n6)Footnote 6. See P 8.04[4] *infra* for a discussion of the built-in gains rule.

(n7)Footnote 7. *I.R.C. § 382(c)*.

(n8)Footnote 8. See *Treas. Reg. § 1.368-1(d)* (applied to section 382 pursuant to the Conference Report to the 1986 amendment of section 382, H.R. Conf. Rep. No. 99 841, at II-189 (1986)).

(n9)Footnote 9. In several recent Notices, the Service announced that stock issued to Treasury pursuant to certain economic stabilization programs, whether owned by Treasury or subsequent holders, is generally treated as stock described in section 1504(a)(4) and is therefore not treated as stock for purposes of section 382 (other than for purposes of section 382(e)(1)). See, e.g., *Notice 2009-38, 2009-18 I.R.B.* (Apr. 10, 2009). In addition, the Notices provide that stock acquired by Treasury will not be considered as increasing Treasury's percentage ownership but will be considered as outstanding stock for purposes of calculating the ownership percentages of other 5% shareholders. In short, these rules are designed to avoid counting such shares when doing so would be detrimental to the corporation in the ownership change analysis, but also to count the shares to the extent doing so would help the corporation.

(n10)Footnote 10. *I.R.C. § 382(g)*. The 3-year testing period is generally the 3-year period prior to the date on which there is a change in the percentage ownership of a 5% shareholder or equity structure shift. *I.R.C. § 382(i)*.

(n11)Footnote 11. In practice, an analysis of 5-percent shareholders and ownership changes is extremely complex and typically requires a thorough review of publicly filed SEC Schedules 13D and 13G of the corporation and its first-tier owners. *Treas. Reg. § 1.382-2T(k)(1)*. The IRS has made this onerous task somewhat easier by ruling on several recent occasions that private investment funds under common management for SEC filing purposes will not be treated collectively as an entity for Section 382 ownership change purposes as long as they make their investment

decisions on a fund-by-fund basis (*i.e.*, the investment decisions of one fund are not based on the investment decisions made by one or more of the other funds). *See, e.g.*, Priv. Ltr. Rul. 2008-06-008 (Nov. 7, 2007); Priv. Ltr. Rul. 2007-47-016 (Aug. 20, 2007); Priv. Ltr. Rul. 2007-13-015 (Dec. 20, 2006). The IRS has also provided practical advice on how ownership change analyses should be performed in the case of non-public loss corporations. Priv. Ltr. Rul. 2006-22-013 (Jan. 27, 2006) .

(n12)Footnote 12. *See P 8.06[3] infra.*

(n13)Footnote 13. *Treas. Reg. § 1.382-4(d)*. Warrants acquired by Treasury pursuant to certain economic stabilization programs, whether owned by Treasury or subsequent holders, are generally treated as either options that will not be deemed exercised for purposes of section 382 or as an ownership interest in the underlying stock (which stock is treated as preferred stock described in section 1504(a)(4) and thus ignored for purposes of the ownership change analysis). *Notice 2009-38, 2009-18 I.R.B.* (Apr. 13, 2009).

(n14)Footnote 14. *Treas. Reg. § 1.382-4(d)(2)(i)*.

(n15)Footnote 15. *Treas. Reg. § 1.382-4(d)(6)(i)*.

(n16)Footnote 16. *Treas. Reg. § 1.382-4(d)(3)*.

(n17)Footnote 17. *Treas. Reg. § 1.382-4(d)(4)*.

(n18)Footnote 18. *Treas. Reg. § 1.382-4(d)(5)*.

(n19)Footnote 19. *Treas. Reg. § 1.382-4(d)(6)(i)*.

(n20)Footnote 20. *Treas. Reg. §§ 1.382-4(d)(7)(i)-(vi)*.

(n21)Footnote 21. *See I.R.C. § 382(b)(3)(B); Treas. Reg. § 1.382-6(a)*.

(n22)Footnote 22. *Treas. Reg. § 1.382-6(b)*.

(n23)Footnote 23. *See I.R.C. §§ 382(h)(1), (3)(B) and (7)(A)*. Under section 382(h)(6)(A), certain income items that are recognized during the recognition period but that are attributable to the period before the ownership change will be treated as recognized built-in gains.

(n24)Footnote 24. *I.R.C. § 382(h)(3)*.

(n25)Footnote 25. *See, e.g., Notice 2003-65, 2003-2 C.B. 747, Notice 2003-65* (Sept. 12, 2003) ; Priv. Ltr. Rul. 91-22-067 (Mar. 6, 1991) ; *see also 1987-2 C.B. 387, Notice 87-79* (Dec. 15, 1987) .

(n26)Footnote 26. Note, however, that since gross built-in gain may exceed the net unrealized built-in gain (which is the maximum increase in the *I.R.C. § 382* limitation permitted), simply coming within these rules does not insure that the section 382 limitation will be increased to the full extent of the COD income realized; careful attention needs to be paid to the facts of the situation at hand.

(n27)Footnote 27. *I.R.C. § 382(h)(1)(B)*.

(n28)Footnote 28. *Treas. Reg. §§ 1.1502-90 through 99*.

(n29)Footnote 29. *Treas. Reg. §§ 1.1502-91(a) and (e)*.

(n30)Footnote 30. *Treas. Reg. § 1.1502-93(b)*. This value is subject to adjustment under various section 382 rules and regulations.

(n31)Footnote 31. *Treas. Reg. § 1.1502-91(g)*.

(n32)Footnote 32. *Treas. Reg. § 1.1502-93(d)*.

(n33)Footnote 33. *Treas. Reg. §§ 1.1502-95(b)(2) and (c)*.

(n34)Footnote 34. *Treas. Reg. § 1.1502-97*. In a 2002 released Field Service Advice, the Service declined to express an opinion on this issue. *See 2002 WL 1315703* (IRS FSA) (undated).

(n35)Footnote 35. *See P 8.06[3] infra* for a discussion of these rules.



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CHAPTER 8 Tax Aspects of Workouts

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P 8.05 Miscellaneous.

[1] State Tax Considerations.

For federal income tax purposes, affiliated corporations may elect to file consolidated returns if one corporation owns 80% or more of the vote and value of the stock of a second corporation.ⁿ¹ However, even if affiliates may file a consolidated return for federal income tax purposes, they may not be permitted to file a consolidated return for state income tax purposes since other restrictions and limitations may apply. Consequently, if debt is issued by a holding company that does not file a consolidated state tax return with its operating subsidiary, interest deductions on such debt may not be available to offset operating income of the subsidiary for state income tax purposes. Furthermore, many states do not permit, or severely restrict the amount and use of, NOL carryovers and some states apply certain code provisions such as Section 382 in a manner that deviates from applicable Treasury Regulations.ⁿ²

[2] Deduction of Unpaid Interest as Expense.

A troubled company may be allowed to deduct accrued but unpaid interest even after it has suspended payments on its debt and is engaged in a workout. Initially, the courts allowed interest deductions so long as there was a reasonable prospect that the debtor would eventually pay the interest.ⁿ³ Subsequently, courts and the Service appear to have become even more lenient, allowing the debtor to deduct interest so long as it could not be "categorically said at the time these deductions were claimed that the interest would not be paid, even though the course of conduct of the parties indicated that the likelihood of payment ... was extremely doubtful."ⁿ⁴ Under current bankruptcy law, claims for interest that accrues on unsecured debt after a bankruptcy petition has been filed are presumptively disallowed.ⁿ⁵ Although this interest may become payable if the plan of reorganization so provides or if the assets of the debtor are sufficient to pay both the interest and principal of the company's debt, the possibility that interest will be paid on unsecured debt is usually remote. Accordingly, the ability to deduct interest on unsecured debt after the filing of a bankruptcy petition has been questionable.ⁿ⁶

The Service clarified its position in recent advice that concluded a taxpayer is entitled to a deduction for interest that accrues from the date the bankruptcy petition is filed, even though the taxpayer's ability to pay the interest is uncertain. The Service observed that while the filing of a bankruptcy petition "created doubt as to the likelihood of the payment of interest" on the taxpayer's pre-petition debt, "the bankruptcy petition did not change [the taxpayer's] obligation to pay the interest."ⁿ⁷

[3] Interest Income.

Under the "doubtful collectibility" rule, an accrual basis creditor may be required to include interest in income even when the debtor fails to pay that interest. The obligation to accrue unpaid interest ceases if the interest is found to be uncollectible when the right to receive it arises.ⁿ⁸ In this context, interest is considered uncollectible when there is substantial uncertainty that the interest will be paid.ⁿ⁹ The rules applicable to interest should also control for purposes of determining the inclusion of OID accruals in income. However, the Service has taken the view that the doubtful collectibility rule does not apply to OID, and that, as a result, holders of a debt instrument with OID must continue to accrue OID until the debt is exchanged or canceled.ⁿ¹⁰ The Service's position is inconsistent with legislative history indicating that the OID rules are an expansion of, and do not replace, the general rules applicable to the accrual method of accounting.ⁿ¹¹

FOOTNOTES:

(n1)Footnote 1. *I.R.C. §§ 1501, 1504(a).*

(n2)Footnote 2. *See, e.g., E. Millar, Imperfect State Conformity to Section 382: Georgia's Unorthodox Approach*, 39 St. Tax Notes 719 (Mar. 6, 2006).

(n3)Footnote 3. *See Brainard v. Comm'r*, 7 T.C. 1180, 1184 (1946), remanded and vacated pursuant to agreement of the parties, 47-2 U.S. Tax. Cas. (CCH) P 9,306.

(n4)Footnote 4. *Cohen v. Comm'r*, 21 T.C. 855, 857 (1954) (citation omitted), *acq.*, 1954-2 C.B. 4; *see also Zimmerman Steel Co. v. Comm'r*, 42-2 U.S. Tax Cas. (CCH) P 9,697 (8th Cir. 1942) (interest deductible without regard to likelihood of repayment).

(n5)Footnote 5. *See 11 U.S.C. § 502(b)(2).*

(n6)Footnote 6. *See In re Cont'l Vending Mach. Corp.*, 77-1 U.S. Tax Cas. (CCH) P 9,121 (E.D.N.Y. 1976) (deduction not allowed); *cf. Kellogg v. United States (In re W. Tex. Mktg. Corp.)*, 155 B.R. 399 (Bankr. N.D. Tex. 1993), *aff'd*, 94-1 U.S. Tax Cas. (CCH) P 50,063 (N.D. Tex. 1993), *aff'd*, 54 F.3d 1194 (5th Cir. 1995) (deduction not allowed for postpetition interest on unsecured, prepetition claims; *Rev. Rul. 70-367*, *infra*, distinguished as dealing with a preexisting debt). *But see Rev. Rul. 70-367*, 1970-2 C.B. 37 (deduction allowed, but under prior Bankruptcy Act); *In re Dow Corning Corp.*, 270 B.R. 393 (Bankr. E.D. Mich. 2001) (some deductions allowed). For a more detailed discussion of the ability of a troubled company to deduct interest as it accrues, *see 15 Collier on Bankruptcy*, P TX15.05 (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. Chief Counsel Adv. 2008-01-039 (Sept. 24, 2007).

(n8)Footnote 8. *See Jones Lumber Co. v. Comm'r*, 404 F.2d 764 (6th Cir. 1968); *European Am. Bank & Trust Co. v. United States*, 20 Cl. Ct. 594 (1990), *aff'd*, 92-1 U.S. Tax Cas. (CCH) P 50,026 (Fed. Cir. 1991); *See also Rev. Rul. 80-361*, 1980-2 C.B. 164 (interest need not be accrued after it became uncollectible due to debtor's insolvency); *Rev. Rul. 81-18*, 1981-1 C.B. 295 (debt written off in accordance with established policy of federal authority is presumed uncollectible). *But see Rev. Rul. 2007-32*, 2007-1 C.B. 1278 (distinguishing *Revenue Ruling 81-18*).

(n9)Footnote 9. *See European Am. Bank & Trust Co. v. United States*, 20 Cl. Ct. 594 (1990), *aff'd*, 92-1 U.S. Tax Cas. (CCH) P 50,026 (Fed. Cir. 1991).

(n10)Footnote 10. *See Tech. Adv. Memo. 95-38-007* (June 13, 1995).

(n11)Footnote 11. *See S. Rep. No. 99-83 at 14* (1985) ("[The OID rules] attempted to prevent mismatching of interest income and interest deductions by requiring both [parties] to account for the interest on the accrual method of

accounting").



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CHAPTER 8 Tax Aspects of Workouts

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P 8.06 Workout Versus Bankruptcy.

[1] Overview.

The following is a comparison of bankruptcies and workouts in the context of the tax issues that may arise in such transactions.

Workouts are often accomplished through the mechanism of an exchange offer, by which a debtor corporation proposes to exchange its existing debt securities for new debt securities with different payment terms and covenant protections and/or equity securities. The offer generally is conditioned upon the consent of holders of a stated percentage of the principal amount of the outstanding debt. That percentage is typically quite high in order to minimize the "free rider" problem, whereby creditors who refuse to consent to a modification of the terms of their debt get the benefits of a restructuring without compromising their payment terms.ⁿ¹

By contrast, the consent provisions required by the bankruptcy laws are less onerous than those typically required under an exchange offer.ⁿ² Moreover, a plan of reorganization in bankruptcy binds all creditors (including non-consenting creditors). Accordingly, many debtors have sought to do a "prepackaged bankruptcy."ⁿ³ In a prepackaged bankruptcy, the issuer secures sufficient consents to assure confirmation of a plan in a chapter 11 case before filing the chapter 11 petition. The issuer then files a chapter 11 petition and seeks swift confirmation of the prepackaged plan. Prepackaged bankruptcies have become a common alternative to out-of-court restructurings.

No matter how abbreviated the chapter 11 case is likely to be, the filing of a petition is a serious matter. The impact on customers and the availability of trade credit must be assessed, as well as the generally greater transaction costs of restructuring in bankruptcyⁿ⁴ and the risk that the prepackaged plan might fail, resulting in a protracted and uncontrolled bankruptcy. In appropriate cases, however, a prepackaged bankruptcy is the best alternative.

[2] Exclusion From Gross Income.

Debt discharge is totally excluded from the general income recognition rule of section 61(a)(12) if the debtor is in a title 11 proceeding.ⁿ⁵ If the debtor is not in a title 11 proceeding, debt discharge generally may only be excluded to the extent of the corporation's insolvency.ⁿ⁶ The measure of a corporation's insolvency is a difficult factual question that could be second guessed by the Service after the restructuring. In addition, there may be considerable transaction costs involved in obtaining an appraisal opinion.

[3] Bankruptcy Reorganizations and Relief From NOL Carryover Limitations Under Section 382.

[a] Bankruptcy Exception: Section 382(l)(5).

Section 382(l)(5) provides relief for certain bankruptcy reorganizations from the section 382 limitation on the use of NOLs after an ownership change.ⁿ⁷ This bankruptcy exception provides that the section 382 limitation does not apply to a corporation in a title 11 or similar caseⁿ⁸ if, as a result of a bankruptcy reorganization, the corporation's shareholders and "old and cold" creditors own (immediately after the reorganization and as a result of being shareholders or creditors immediately before such reorganization) stock (other than straight preferred stock) possessing at least 50% of the vote and value of the corporation's stock.ⁿ⁹ For purposes of determining whether the 50% stock ownership requirement is met, stock options are generally deemed exercised if that deemed exercise would cause the pre-change shareholders and "old and cold" creditors to fail the 50% requirement.ⁿ¹⁰ Taxpayers availing themselves of the bankruptcy exception are subject to a modified form of NOL reduction, described below.ⁿ¹¹ Remaining NOLs, however, may offset post-change income without limitation and without regard to whether the historic business of the corporation is continued.ⁿ¹²

"Old and cold" creditors generally consist of creditors who either held their debt for at least 18 months before the filing of the bankruptcy case, or whose debt arose in the ordinary course of the corporation's business and who have held the beneficial interest in such debt at all times.ⁿ¹³ Treasury regulations provide that, for purposes of determining whether a creditor is "old and cold," the beneficial owner of the debt immediately prior to the ownership change will generally be treated as having always owned the debt if the beneficial owner is not a 5% shareholder of the loss corporation immediately after the ownership change.ⁿ¹⁴ A tacking rule applies to debt obtained in a debt-for-debt exchange, whereby the holder is treated as having owned new debt obtained in the exchange for the period it owned the old debt.ⁿ¹⁵ Claims arising from the rejection of burdensome contracts or leases pursuant to a title 11 or similar reorganization are treated as arising in the ordinary course of the corporation's business if the underlying contract or lease arose in the ordinary course of the corporation's business.ⁿ¹⁶ These rules make it important to attempt to restrict trading in a corporation's "old and cold" debt securities after a Title 11 filing of the bankruptcy case, in order to prevent a new large "hot" holder of debt from emerging and making a section 382(l)(5) reorganization impossible. For this reason, bankruptcy courts frequently issue orders imposing restrictions on trading of equity and creditor claims that are tailored to prevent an ownership change and to maintain a stable population of "old and cold" debt holders for a possible future section 382(l)(5) reorganization.ⁿ¹⁷

The Service has carefully scrutinized purported section 382(l)(5) reorganizations to ensure that they are not abused to achieve results contrary to the policies of section 382. For example, in one Chief Counsel Advice, the Service has suggested that, in order to qualify for relief under section 382(l)(5), a "sufficient proportion ... (preferably 50 percent)" of "old and cold" debtholders should retain their stock in the debtor for a non-transitory period of time after the bankruptcy plan is consummated.ⁿ¹⁸ In another Chief Counsel Advice, it concluded that section 382(l)(5) did not apply to a debt restructuring because, although structured to qualify under section 382(l)(5), the transaction (including prices per share that were paid for contributions and redemptions) did not reflect economic reality. In substance, the overall transaction had allowed an acquiring corporation (which was not an old and cold creditor or shareholder) to purchase 100% of the loss corporation via several steps within a single year.ⁿ¹⁹

If section 382(l)(5) is applicable, the loss corporation must reduce its NOLs by the amount of interest on debt converted into stock pursuant to the bankruptcy reorganization that was paid or accrued during the portion of the current tax year prior to and including the date of the ownership change and during any preceding tax year which ended during the 3 taxable years prior to that date.ⁿ²⁰ However, debt representing such interest will be treated as not giving rise to COD income.ⁿ²¹ Section 382(l)(5) is regarded as the "broken business" bankruptcy exception, since corporations with excessive trade claims (but not excessive interest-bearing debt) are most likely to benefit from the section 382(l)(5) exception.ⁿ²²

If a second ownership change occurs within two years of the ownership change to which the bankruptcy exception applies, the section 382 limitation with respect to the second ownership change becomes zero.ⁿ²³ (The second ownership change does not, however, result in a retroactive disqualification of the first ownership change from section 382(l)(5)).ⁿ²⁴ Because of the severity of this sanction, suitable safeguards (*e.g.*, shareholders' agreement, charter restrictions) should be put in place to avoid a second ownership change.

The potentially devastating results of a second ownership change make it important to establish the precise date on which the first ownership change occurred. It would appear that the relevant date for section 382 purposes is the date of consummation of the plan of reorganization, when the debtor's pre-petition debts are wiped out, and not the date of confirmation of the plan of reorganization, when the debtor is merely authorized to proceed with a restructuring whose consummation is not guaranteed.ⁿ²⁵

[b] Special Rule: Section 382(l)(6).

A corporation may elect to forgo the bankruptcy exception and instead avail itself of the special rule found in section 382(l)(6) for computing the section 382 limitation. This special rule is generally beneficial in instances of failed leveraged buyouts and for corporations with excessive interest-bearing debt.ⁿ²⁶

In general, for purposes of computing the section 382 limitation, the value of the loss corporation is determined immediately before the ownership change.ⁿ²⁷ In the case of a taxpayer in a title 11 or similar case, or a party to a "G" reorganizationⁿ²⁸ that does not qualify for, or elects out of, the benefit of section 382(l)(5), section 382(l)(6) provides that the section 382 limitation is computed by reflecting the increase in value of the corporation resulting from the surrender or cancellation of creditors' claims. Treasury regulations extend the benefits of section 382(l)(6) to corporations that indirectly exchange stock for debt by issuing stock for cash and using the proceeds to satisfy their outstanding debt.ⁿ²⁹ For purposes of section 382(l)(6), the value of the loss corporation is the lesser of (i) the value of the stock of the loss corporation determined immediately after the ownership change, or (ii) the value of the loss corporation's assets (determined without regard to any liabilities) immediately before the ownership change.ⁿ³⁰ This provision tends to increase the section 382 limitation and is advantageous for the restructured corporation.

Section 269 disallows deductions and other tax benefits when tax avoidance is the principal purpose for the acquisition of control of a company.ⁿ³¹ Regulations under section 269 provide that, absent strong evidence to the contrary, an acquisition of control in connection with an ownership change to which section 382(l)(5) otherwise applies is considered to be made for the principal purpose of tax avoidance unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case.ⁿ³² The determination of whether the corporation carries on more than an insignificant amount of an active trade or business is based on all the facts and circumstances, which include the amount of business assets that continue to be used and the number of employees in the work force who continue employment in an active trade or business (although not necessarily the corporation's historic trade or business). If the corporation continues to utilize a significant amount of its historic business assets or work force, it may be deemed to be carrying on more than an insignificant amount of an active trade or business even though all trade or business activities temporarily cease.ⁿ³³ The regulations indicate that the Service is not bound by a determination of a court under *11 U.S.C. section 1129(d)* that the principal purpose of the plan of reorganization is not avoidance of taxes.ⁿ³⁴

[4] Tax-Free Reorganizations.

A restructuring of the debt of a single corporation, whether in a bankruptcy or workout, will typically constitute a recapitalization qualifying as a tax-free reorganization.ⁿ³⁵ If the restructuring involves an acquisition or a combination of more than one company, it will not constitute a recapitalization. It may, however, constitute another form of corporate reorganization under section 368. It is often desirable to qualify as a reorganization in order that the transfer of assets and liabilities of the troubled company and the exchange of stock of the troubled company by its shareholders

may be carried out tax-free. Although there are several ways in which a corporation involved in a workout may reorganize tax-free, a "G" reorganization is available only to corporations reorganizing under chapter 11.ⁿ³⁶

A "G" reorganization is defined in section 368(a)(1)(G) as a transfer by a corporation of all or part of its assets to another corporation in a title 11 proceeding, or similar case,ⁿ³⁷ but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction that qualifies under section 354, 355 or 356. In order to meet these requirements, the debtor corporation must usually transfer "substantially all" of its assets to the new corporation. For private letter ruling purposes, the Service has interpreted "substantially all" in the context of other reorganization provisions containing that requirement to mean 70% of the fair market value of the corporation's gross assets, and 90% of the fair market value of its net assets.ⁿ³⁸ The legislative history to section 368(a)(1)(G), however, indicates that the test is more lenient in the "G" reorganization context.ⁿ³⁹

Consequently, a troubled company in chapter 11 may have more flexibility in reorganizing tax-free in that it can choose to carry out a "G" reorganization, while a company out of bankruptcy would have to meet the more rigid requirements of other types of tax-free reorganizations.

As discussed above, attribute reduction under section 108(b) occurs after the end of the taxable year.ⁿ⁴⁰ Furthermore, it applies to the tax attributes "of the taxpayer."ⁿ⁴¹ Under section 381(b), the taxable year of the transferor corporation in a "G" reorganization ends on the date of the transfer. Since the assets of the taxpayer have already been transferred to the acquiring corporation, the only remaining attribute "of the taxpayer" (putting aside any consolidated NOLs) in the following tax year may be its basis in the stock of the acquiring corporation. Since the transferor will not recognize gain or loss on the distribution of such stock to its shareholders or creditors, a reduction of that stock's basis to zero is harmless to the transferor. Accordingly, under this reading of the Code, a "G" reorganization might not result in any tax or meaningful attribute reduction despite triggering COD income.ⁿ⁴² The Treasury Regulations, however, take the position that, in the case of a transaction described in section 381(a) such as a "G" reorganization, any tax attributes to which the acquiring corporation succeeds and the basis of property acquired in the transaction shall reflect attribute reductions required by section 108(b).ⁿ⁴³

The Service has attempted with newly proposed regulations to resolve long-standing uncertainty over how subchapter C's nonrecognition rules apply to transactions involving insolvent corporations. Generally, the proposed regulations would require an "exchange of net value" in order for nonrecognition to apply. An asset transaction would qualify only if (1) the fair market value of property transferred by the target corporation exceeds the sum of the liabilities of the target assumed by the acquirer and the amount of any money and the fair market value of other property (other than stock permitted to be received without recognition of gain under section 361(a)) received by the target in connection with the exchange and (2) the fair market value of the assets of the issuing corporation exceeds its liabilities following the exchange.ⁿ⁴⁴ Similar requirements have been proposed with respect to stock transactions, including purported section 351 transfers.ⁿ⁴⁵

[5] Continuity of Interest.

Courts have held that one requirement common to all reorganizations (other than recapitalizations) is that shareholders of a target company must maintain a continuing proprietary interest in the surviving company.ⁿ⁴⁶ This requirement is generally referred to as the "continuity of interest" requirement, and is not applicable to recapitalizations.ⁿ⁴⁷ In accordance with the case law discussed below, the continuity of interest requirement is more flexible in the bankruptcy context.

Helvering v. Alabama Asphaltic Limestone Co. ⁿ⁴⁸ holds that in limited circumstances, creditors of the old target company who receive stock in the new acquiring company may be treated as equity owners of the old company for purposes of applying the continuity of interest test. This rule generally only applied when the creditors have taken command of the old company by the institution of an appropriate bankruptcy or other creditor's proceeding. Thus, more

flexible continuity of interest requirements was historically a possible advantage of a bankruptcy reorganization. Under recently finalized Treasury Regulations, stock received by creditors of the old target company will generally count for purposes of applying the continuity of interest test, both inside and outside of a bankruptcy proceeding, to the extent of the value of the proprietary interest represented by the creditors' claims.ⁿ⁴⁹ For the most senior class of creditors receiving stock in the exchange, the value of such creditors' proprietary interest represented by a claim is determined by multiplying the fair market value of the claim by a fraction, the numerator of which is the fair market value of the target stock received by all senior creditors, and the denominator of which is the value of all consideration (including target stock) received by all senior creditors.ⁿ⁵⁰ For junior creditors, the entire fair market value of the claim represents the value of the proprietary interest in the old target company.ⁿ⁵¹

Under flexible regulations finalized in 1998, the shareholders of the target need not retain their shares of the surviving company after the reorganization, and generally all that is required is only that the percentage of the total value of consideration issued in the reorganization that is comprised of shares of the surviving corporation be adequate.ⁿ⁵² For purposes of determining the requisite percentage, the rules discussed earlier would continue to apply. Therefore, shareholders of the target corporation may dispose (otherwise than through a redemption) immediately of shares of the surviving corporation received in the reorganization without jeopardizing the tax-free status of the reorganization.

[6] Private Rulings.

In a chapter 11 case, taxpayers will have time to seek private rulings, whereas taxpayers may not have time to seek rulings in a workout situation. Depending on the circumstances, a taxpayer may, therefore, have greater certainty with respect to the outcome of tax issues in a bankruptcy case.

FOOTNOTES:

(n1)Footnote 1. Outside of bankruptcy, holdout creditors cannot have their payment terms modified without their consent, see Trust Indenture Act § 316 (codified at 15 U.S.C. § 77ppp(b)), although their covenants may be stripped in a successful exchange offer.

(n2)Footnote 2. A bankruptcy plan requires, with respect to a class of impaired claims, the acceptance of at least two-thirds in amount and more than one-half in number of the allowed claims voting on the plan, and with respect to a class of non-creditor interests, the acceptance of at least two-thirds in amount of the allowed interests voting on the plan. 11 U.S.C. § 1126(c) and (d). A class is treated as "impaired" if the plan alters the legal, equitable or contractual rights of class members. 11 U.S.C. § 1124.

(n3)Footnote 3. Under 11 U.S.C. § 1126(b), a debtor may solicit acceptances for a plan before filing a bankruptcy petition. Such a plan is considered to be "prepackaged." For a discussion of prepackaged bankruptcies, see P 6.02 *et seq. supra*.

(n4)Footnote 4. See P 2.07[1][b][iii] *supra*.

(n5)Footnote 5. See I.R.C. § 108(a)(1)(A).

(n6)Footnote 6. See I.R.C. § 108(a)(3).

(n7)Footnote 7. For a discussion of the limitations generally imposed by I.R.C. § 382 on carryovers of NOLs, see P 8.04[1]-[4] *supra*.

(n8)Footnote 8. A "similar case" is a receivership, foreclosure or similar proceeding in a federal or state court. I.R.C. § 368(a)(3). The complete exclusion of debt discharge from income under the bankruptcy exception applies only to debtors in title 11 cases, and not to debtors in similar cases. I.R.C. § 108(a)(1)(A).

(n9)Footnote 9. I.R.C. § 382(l)(5)(A).

(n10)Footnote 10. *Treas. Reg. § 1.382-9(e)(1)*.

(n11)Footnote 11. *I.R.C. §§ 382(l)(5)(B), (C)*.

(n12)Footnote 12. However, the use of NOLs to offset post-change income may be precluded unless the corporation carries on "more than an insignificant amount" of an active trade or business during and after the title 11 or similar case. *See* ns. 31-34 and accompanying text *infra* (discussing *I.R.C. § 269* and regulations promulgated thereunder).

(n13)Footnote 13. *See I.R.C. § 382(l)(5)(E)*.

(n14)Footnote 14. *Treas. Reg. § 1.382-9(d)(3)(i)*.

(n15)Footnote 15. *Treas. Reg. § 1.382-9(d)(5)(iv)*.

(n16)Footnote 16. *Treas. Reg. § 1.382-9(d)(2)(iv)*.

(n17)Footnote 17. *See, e.g.,* Jean Morris, *Imposition of Transfer Limitations on Claims and Equity Interests During Corporate Debtor's Chapter 11 Case to Preserve the Debtor's Net Operating Loss Carryforward: Examining the Emerging Trend*, 77 *Am Bankr. L.J.* 285, 289 n.18 (2003) (citing cases); Priv. Ltr. Rul. 2007-13-015 (Dec. 20, 2006); Priv. Ltr. Rul. 2006-05-003 (Oct. 28, 2005).

(n18)Footnote 18. Chief Counsel Adv. 2004-44-002 (Oct. 29, 2004).

(n19)Footnote 19. Chief Counsel Adv. 2009-15-033 (Apr. 10, 2009).

(n20)Footnote 20. *I.R.C. § 382(l)(5)(B)*. The disallowance of NOLs has the effect of retractively recharacterizing the interest paid on the debt as dividends paid on stock.

(n21)Footnote 21. *I.R.C. § 382(l)(5)(C)*.

(n22)Footnote 22. *See* K. Malek & W. Thomas, *New Section 382(1)(5) and (1)(6) Regulations Provide Relief in Certain Corporate Bankruptcy Restructurings*, 70 *Taxes* 715, 717 (1992).

(n23)Footnote 23. *I.R.C. § 382(l)(5)(D); Treas. Reg. § 1.382-9(n)(1)*.

(n24)Footnote 24. *See* Priv. Ltr. Rul. 2007-51-011 (Sept. 7, 2007) .

(n25)Footnote 25. *See generally* *Treas. Reg. § 1.382-9(o)* (implying that creditors are generally viewed as option holders during the period between confirmation date and effective date). *See also* Priv. Ltr. Rul. 2007-48-015 (Aug. 21, 2007).

(n26)Footnote 26. *See* Malek & Thomas, n.22 *supra*, at 717.

(n27)Footnote 27. *I.R.C. § 382(e)(1)*.

(n28)Footnote 28. *See* P 8.06[4] *infra*.

(n29)Footnote 29. *Treas. Reg. § 1.382-9(j)*.

(n30)Footnote 30. *Treas. Reg. §§ 1.382-9(j) and (l)(1)*.

(n31)Footnote 31. *See I.R.C. § 269(a)*.

(n32)Footnote 32. *Treas. Reg. § 1.269-3(d)(1)*.

(n33)Footnote 33. *Id.*

(n34)Footnote 34. *See Treas. Reg. § 1.269-3(e)*.

(n35)Footnote 35. *See P 8.08[1] infra* for further discussion of tax-free recapitalizations.

(n36)Footnote 36. *See generally* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* P 12.30 (WG&L 7th ed. 2000 & Supp. 2008).

(n37)Footnote 37. A "similar case" means a receivership, foreclosure, or similar proceeding in a federal or state court. *I.R.C. § 368(a)(3)*.

(n38)Footnote 38. *Rev. Proc. 86-42, 1986-2 C.B. 722 ; Rev. Proc. 77-37 § 3.01, 1977-2 C.B. 568 .*

(n39)Footnote 39. Bankruptcy Tax Act of 1980, H.R. Rep. No. 96-833, at 31 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 96-1035, at 35-36 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). Note also that as a prerequisite to favorable rulings on "G" reorganizations involving non-financial institutions, the Service requires a representation that 50% of the fair market value of the gross assets and 70% of the fair market value of the operating assets are being acquired. *See* Priv. Ltr. Rul. 94-09-037 (Dec. 7, 1993) ; Priv. Ltr. Rul. 93-35-029 (June 4, 1993) ; Priv. Ltr. Rul. 85-03-064 (Oct. 24, 1984) . In rulings on "G" reorganizations involving financial institutions, the Service may require a representation that 50% of the fair market value of the gross assets and 90% of the fair market value of the operating assets are being acquired. *See* Priv. Ltr. Rul. 92-31-052 (May 6, 1992) ; Priv. Ltr. Rul. 90-02-062 (Oct. 18, 1989) . *But see* Priv. Ltr. Rul. 89-09-007 (Nov. 30, 1988) (70% of operating assets).

(n40)Footnote 40. *See P 8.03[1] supra*.

(n41)Footnote 41. *I.R.C. § 108(b)(1)*.

(n42)Footnote 42. Indeed, the IRS had issued a Field Service Advice in 2001 that reached precisely this result. *FSA 200145009* (July 31, 2001) , *citing* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* P 12.30[3] & n.552 (WG&L 7th ed. 2000 & Supp. 2008).

(n43)Footnote 43. *See Treas. Reg. § 1.108-7(c)*.

(n44)Footnote 44. *Prop. Treas. Reg. § 1.368-1(f)(2)*.

(n45)Footnote 45. *Prop. Treas. Regs. §§ 1.368-1(f)(3) and 1.351-1(a)(1)(iii)*.

(n46)Footnote 46. *See Sw. Natural Gas Co. v. Comm'r, 189 F.2d 332 (5th Cir.) , cert. denied, 342 U.S. 860, 72 S. Ct. 88, 96 L. Ed. 647 (1951) .*

(n47)Footnote 47. *See Hickok v. Comm'r, 32 T.C. 80, 88 (1959) , nonacq., 1959-2 C.B. 8 , nonacq. withdrawn, 1977-2 C.B. 3 ; Treas. Reg. § 1.368-1(b)*.

(n48)Footnote 48. *315 U.S. 179, 62 S. Ct. 540, 86 L. Ed. 775 (1942) .*

(n49)Footnote 49. *Treas. Reg. § 1.368-1(e)(6)(i)*.

(n50)Footnote 50. *Treas. Reg. § 1.368-1(e)(6)(ii)(A)*. If only one class of creditors receives stock in the exchange, such class is treated as the most senior class receiving stock in the exchange.

(n51)Footnote 51. *Treas. Reg. § 1.368-1(e)(6)(ii)(B)*.

(n52)Footnote 52. *Treas. Reg. § 1.368-1(e)(1)*. The regulations provide that a proprietary interest in the target corporation is not preserved if shares of the acquiring corporation issued in exchange for a proprietary interest in the target corporation are subsequently redeemed. *Treas. Reg. § 1.368-1(e)(1)(i)*. A proprietary interest is also not preserved where persons related to the acquiring corporation acquire stock of the target corporation with consideration other than a proprietary interest in the acquiring corporation (except to the extent that former owners of the target corporation maintain a proprietary interest in the acquiring corporation). *Treas. Reg. § 1.368-1(e)(3)*.



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CHAPTER 8 Tax Aspects of Workouts

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P 8.07 Strategies.

This paragraph will consider various strategies that may be used to optimize the tax consequences of a restructuring for a troubled company.

[1] Flexibility to Trade COD for OID or Interest Deductions in the Case of Privately Issued Debt.

In the case of publicly traded debt, there is very little flexibility to structure an exchange offer in a manner that optimizes the mix of COD and OID/interest deductions for the restructured corporation. This lack of flexibility exists because the issue price of the newly issued publicly traded debt will always be its fair market value, determined by its trading price.ⁿ¹ By contrast, when dealing with nonpublicly traded debt, the issue price will equal the stated principal amount, without regard to actual value, so long as the stated interest rate is at least equal to the AFR.ⁿ² Accordingly, with non-publicly traded debt within the band of interest rates between AFR and the AHYDO trigger rate (or higher, in certain circumstances),ⁿ³ it is possible to achieve tradeoffs, *e.g.*, increased COD with higher OID or interest deductions, or reduced COD with lower OID or interest deductions. These tradeoffs may be achieved without modifying the cash flow on the debtⁿ⁴ by simply assigning different principal amounts and interest rates to any agreed cash payment schedule.

For example, if a company could shelter COD income (because it is sufficiently insolvent or is in bankruptcy or has NOLs), and attribute reduction is not a problem (because the company does not have valuable tax attributes or there will be an ownership change under section 382), the company could structure its new debt with a low face amount and a high interest rate. The company would realize current COD income equal to the difference between the face amount of the new debt and the adjusted issue price of the old debt. That COD income would be sheltered and the company would have higher OID or interest deductions in the future, subject to application of the AHYDO rules.ⁿ⁵

On the other hand, if a company's tax position is such that it needs to avoid realization of COD income (because it is neither insolvent nor bankrupt and does not have sufficient NOLs), the stated interest rate on any new debt instrument should be the AFR. This would maximize the issue price of the new debt instrument, and thereby minimize COD income. The trade-off would be that the company would have lower OID or interest deductions in the future.

To illustrate, assume that a 10-year debt instrument with annual payments of \$30 and an additional payment at maturity of \$500 is issued in exchange for an old debt instrument with an adjusted issue price of \$1,000. Assume the AFR is

equal to 6% and that neither the new nor the old debt instrument is publicly traded. In theory, without modifying the payment terms, the amount of current COD triggered--and, as a consequence, OID created--can be varied by simply stating different combinations of principal amount and interest rate, as set forth in the table below.

<i>Interest Rate</i>	<i>Stated Principal Amount</i>	<i>COD Income/OID- Interest Deductions</i>
6.00	500	500
7.00	465	535
8.00	433	567
9.00	404	596
10.00	377	623
10.99	353	647

If the foregoing technique is used, careful attention should be paid to the provisions of the debt instrument dealing with creditors' rights upon a default. If the stated principal amount and interest rate are to be respected for tax purposes, they must be consistent with the amount the creditor will receive in any circumstance in which maturity is accelerated, *i.e.*, the creditor's claim should equal the stated principal amount plus accrued and unpaid interest at the stated rate (plus, perhaps, a reasonable call premium).⁶ In the above example, if 6% is the stated interest rate, then the holder should receive \$500 upon any acceleration of maturity. In contrast, if the issuer stated 10.99% interest, the accreted principal amounts that should govern upon call or acceleration would be as follows:

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The foregoing discussion demonstrates that there continues to be a reasonable degree of room for tax planning when dealing with nonpublicly traded securities. Accordingly, there may be circumstances in which an issuer seeks to preclude trading of its debt. Regulations provide that any property subject to a temporary restriction on trading (whether or not imposed by the issuer), a purpose of which is to avoid characterization as publicly traded for federal income tax purposes, will be treated as publicly traded.⁸

[2] Bankruptcy.

Although historically tax issues have not been a material factor in the determination of whether or not to file for relief under chapter 11, in the case of a solvent issuer without NOLs that needs to avoid COD income and cannot take advantage of the strategy described above⁹ for non-publicly traded debt, bankruptcy (perhaps a prepackaged bankruptcy)¹⁰ may be the only viable option for a successful restructuring. In addition, there are other advantages to bankruptcy from a tax point of view, such as the availability of either section 382(l)(5) or 382(l)(6).¹¹

[3] Allocating Payments Between Interest and Principal.

A common issue in debt restructurings is the question of how to characterize the receipt of a payment in discharge of a debt obligation where the creditors have claims for both principal and unpaid interest (often the case). *Treasury Regulation § 1.446-2(e)* appears to mandate that payments first be applied to accrued interest. This produces the rather anomalous result that a creditor may receive aggregate payments on an instrument that are less than the original principal amount, but nevertheless have a portion characterized as interest. The problem is that while section 446 Regulations make eminent sense as part of the Internal Revenue Code's treatment of the time value of money in the case of non-distressed instruments, they don't work well in workouts. Notwithstanding the reasonably clear language of the

regulation, taxpayers ought to be able to report all payments as allocable first to principal in a workout.ⁿ¹² Many bankruptcy plans have actually provided for such an allocation.

As a general matter, the company will tend to be neutral as between allocating payments to principal or interest. Creditors may desire to allocate payments to principal and not to accrued interest because a cash-method holder will be taxable on payments allocated to accrued interest, even if the restructuring constitutes a recapitalization.ⁿ¹³ An accrual-method holder who previously included accrued but unpaid interest, including OID, in income should be allowed an ordinary loss deduction for interest not paid.ⁿ¹⁴

For example, assume a company exchanges new debt with an issue price of \$700 for its outstanding debt with an adjusted issue price of \$1,000 and \$100 of accrued but unpaid interest for the current year. If the payment is allocated first to accrued interest, the company will have a \$100 interest deduction and COD income of \$400 (\$1,000 - (\$700 - \$100)). A cash-method holder will have \$100 of interest income and an unrealized loss of \$400 on the old debt if the exchange constitutes a recapitalization. An accrual-method holder would most likely have already included the interest in income.

If, however, the payments were allocated to principal, the company would recognize \$300 of COD income (\$1,000 - \$700) and have no interest deduction. A cash-method holder would have no interest income and a deferred loss of \$300 (\$1,000 - \$700) if the restructuring constitutes a recapitalization. An accrual-method holder would have an ordinary loss to the extent of unpaid accrued interest previously included in income.

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 1273(b)(3); Treas. Reg. § 1.1273-2(b)(1).*

(n2)Footnote 2. *See I.R.C. § 1274; Treas. Reg. § 1.1273-2(d)(1).*

(n3)Footnote 3. Stating an interest rate below AFR will not accomplish anything, since *I.R.C. § 1274* will impute an interest rate equal to the AFR in that circumstance. Stating an interest rate of the AHYDO trigger rate or higher would require an analysis of the AHYDO rules, discussed in *P 8.02[3] supra*, to determine if there will be a limitation on interest deductibility. *See PP 8.02[1] and [3] supra.*

(n4)Footnote 4. *See* n.6 and accompanying text *infra* concerning the importance of call and default provisions being consistent with the stated principal and interest.

(n5)Footnote 5. *See P 8.02[3] supra* for a discussion of the AHYDO rules.

(n6)Footnote 6. The foregoing technique of altering the issue price of the new debt by changing the stated interest rate could be overridden by future regulations under section 1274(b)(3), which provides for a fair market issue price in any "potentially abusive situation." *See Treas. Reg. § 1.1274-3.*

(n7)Footnote 7. The amounts set forth in the table were computed to the penny, starting with an issue price of \$353.00, and then rounded to the nearest dollar.

(n8)Footnote 8. *Treas. Reg. § 1.1273-2(f)(6).* For a discussion of when property is publicly traded, *see P 8.02[2] supra.*

(n9)Footnote 9. *See P 8.07[1] supra.*

(n10)Footnote 10. *See P 8.06[1], n.3 and accompanying text supra.*

(n11)Footnote 11. *See P 8.06[3] supra* for a discussion of *I.R.C. §§ 382(l)(5) and (6).*

(n12)Footnote 12. For a more detailed discussion of this issue, see D. Garlock, *Federal Income Taxation of Debt Instruments*, §§ 603.01 & 1602.01 (CCH 5th ed. 2005 & Supp. 2009).

(n13)Footnote 13. See *I.R.C. § 354(a)(2)(B)*.

(n14)Footnote 14. See *I.R.C. § 166*; *Treas. Reg. § 1.166-1(e)*. See also *Rev. Rul. 81-18, 1981-1 C.B. 295*; S. Rep. No. 96-1035, at 38 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).



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P 8.08 Consequences to Holders.

[1] Tax-Free Recapitalizations.

An exchange of new debt for old debt of the same corporation should qualify as a tax-free recapitalization, so long as the old debt and the new debt constitute "securities."ⁿ¹ The determination of whether the instrument constitutes a security for tax purposes is different than the determination for non-tax purposes. Although the term of the security is only one of the relevant factors, the general rule usually applied in practice is that instruments with a term of ten years or more are securities while instruments with a term of five years or less are not. Instruments with a term of between five and ten years occupy a gray area.ⁿ²

If the exchange qualifies as a recapitalization, a creditor will recognize neither gain nor loss on the receipt of stock of the issuer or on the receipt of a new security.ⁿ³ However, gain will be recognized (i) to the extent the creditor receives cash or property other than stock or securities of the debtor, (ii) to the extent of the fair market value of the excess of the principal amount of the new security over the principal amount of the old security,ⁿ⁴ or (iii) to the extent that the new debt received is attributable to accrued, but unpaid, interest on the old debt.ⁿ⁵ No loss may be recognized.ⁿ⁶

A creditor's basis in the new stock or security will be equal to its basis in the old security, reduced by the fair market value of property not permitted to be received tax free and the amount of money received, and increased by any gain recognized on the exchange.ⁿ⁷ The holding period of the new security or stock will include the holding period of the old security.ⁿ⁸ Property not permitted to be received tax free will have a fair market value basis and will have a new holding period.ⁿ⁹

Either section 1274 or section 1273 (in the case when either the old debt or the new debt is publicly traded) will apply to determine the issue price of the new debt. OID will often be created, which must be reported by the holder as it economically accrues. For original purchasers of the old debt instrument (or other holders with a high carryover basis), the additional OID inclusions will be reduced or eliminated under section 1272(a)(7).ⁿ¹⁰ In effect, holders with a basis in the new debt greater than its issue price ("acquisition premium") should be able to offset OID inclusions by amortizing the acquisition premium or, in the case of accrual method holders, by treating the new debt as if received on original issuance and accruing any OID on a constant yield basis.ⁿ¹¹ In the case of holders that purchased their old securities at a discount in the secondary market, however, the debt-for-debt swap may effectively convert market discount into OID. These holders would be required to report the OID income on a current basis as it accrues. By

contrast, market discount ordinarily would be included in income only when the debt is sold or repaid.ⁿ¹² Thus, for example, if a debt instrument's original issue price is its face amount of \$1,000, and a buyer subsequently purchases it for \$500 and exchanges it in a tax-free recapitalization for new debt with an issue price of \$500 but a face amount of \$1,000, the new debt will have OID of \$500. The buyer's market discount of \$500 would be converted into OID, which would have to be included in the buyer's income on a current basis, and the new debt would not have acquisition premium to offset the OID.

If the old equity holders are wiped out in the restructuring, they should be able to claim a worthless stock deduction under section 165. Where a former shareholder is also a debt holder and receives some stock or securities in the exchange, the availability of the worthless stock deduction is not free from doubt. However, where other equity holders receive nothing in exchange for their stock, the better answer is that no "exchange" took place with respect to the stock, the taxpayer received nothing in his capacity as shareholder, and the loss on the stock should now be recognized.ⁿ¹³

If a shareholder claiming a worthless stock deduction is a member of the debtor's consolidated group, additional requirements may have to be met in order for the deduction to be allowed.ⁿ¹⁴ Furthermore, worthlessness of a consolidated subsidiary (or a deconsolidation of that subsidiary from the group upon the consummation of the bankruptcy restructuring) may trigger taxable income from ELAs with respect to the stock of that subsidiary held by other members of the consolidated group.ⁿ¹⁵ Finally, in certain circumstances the worthless stock deduction with respect to an affiliated subsidiary may give rise to an ordinary, rather than capital, loss deduction.ⁿ¹⁶

[2] Non-Recapitalization Exchanges.

If debt is restructured in a non-recapitalization transaction (*e.g.*, if the old and new debt are not issued by the same corporation), the holder will recognize gain or loss in an amount equal to the difference between its amount realized and its adjusted basis in the old debt. The amount realized is measured by the issue price of the new obligation.ⁿ¹⁷ A holder that has previously taken a bad debt deduction under section 166 with respect to the troubled debt or who purchased the debt at a market discount will recognize gain on the exchange to the extent the issue price of the new debt (or possibly the fair market value, as discussed above) exceeds the holder's adjusted basis in the old debt. Since debt restructurings typically involve losses for the holder, nonrecapitalization exchanges have the advantage of permitting current loss recognition. When gain is realized on the exchange, the holder would normally prefer recapitalization treatment, although the transaction may qualify for installment reporting under section 453.ⁿ¹⁸ Accordingly, different holders may have conflicting interests as to how the workout should be structured.

FOOTNOTES:

(n1)Footnote 1. *I.R.C. §§ 354(a) and 368(a)(1)(E).*

(n2)Footnote 2. *Burnham v. Comm'r*, 86 F.2d 776 (7th Cir. 1936) , *cert. denied*, 300 U.S. 683, 57 S. Ct. 753, 81 L. Ed. 886 (1937) .

(n3)Footnote 3. *I.R.C. § 354(a).* See B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* P 3.03[2] (WG&L 7th ed. 2000 & Supp. 2008).

(n4)Footnote 4. *I.R.C. § 356.* See *Treas. Reg. § 1.356-1*. For this purpose, "principal amount" should mean issue price. See G. Henderson & S. Goldring, *Tax Planning for Troubled Corporations: Bankruptcy and Nonbankruptcy Restructurings* § 403.1.1 (CCH 2009).

(n5)Footnote 5. *I.R.C. § 354(a)(2)(B).*

(n6)Footnote 6. *I.R.C. § 356(c).*

(n7)Footnote 7. *I.R.C. § 358(a)(1).*

(n8)Footnote 8. *I.R.C. § 1223.*

(n9)Footnote 9. *I.R.C. §§ 358(a)(2) and 1223.*

(n10)Footnote 10. *Treas. Reg. § 1.1272-2.*

(n11)Footnote 11. *Treas. Reg. § 1.1272-2(b)(5).*

(n12)Footnote 12. *I.R.C. § 1276(a).* Holders who purchase debt at discount in the secondary market may elect to include the market discount in income currently. *See I.R.C. § 1278(b).* Certain recharacterization, recognition and interest disallowance rules apply to market discount bonds. *See I.R.C. §§ 1276-1278.*

(n13)Footnote 13. *See, e.g., Tiscornia v. Comm'r*, 95 F.2d 678 (9th Cir. 1938) ; *Stearns v. Kavanagh*, 41-2 U.S.T.C. (CCH) P 9750 (E.D. Mich. 1941) . *See also Delk v. Comm'r*, 113 F.3d 984 (9th Cir. 1997) ; *Comm'r v. Spaulding Bakeries, Inc.*, 252 F.2d 693 (2d Cir. 1958) . *But see United Gas Improvement Co. v. Comm'r*, 142 F.2d 216 (3d Cir. 1944) .

(n14)Footnote 14. *See, e.g., Treas. Regs. §§ 1.337(d)-2, 1.1502-35 and 1.1502-80T(c).* *See also* Tech. Adv. Mem. 2005-49-007 (Aug. 5, 2005) (addressing various issues raised by a worthless stock deduction with respect to a consolidated subsidiary). Recently issued final regulations will under certain circumstances impose a "Unified Loss Rule" on members of a consolidated group that transfer shares of subsidiary stock at a loss. *T.D. 9424* (Sept. 10, 2008). The rules--which became effective on September 17, 2008 and are principally lodged in *Treas. Reg. S 1.1502-36*, are both complex and flexible, allowing for a substantial amount of planning when loss subsidiaries are being disposed of.

(n15)Footnote 15. *Treas. Reg. § 1.1502-19(c)(1)(iii).*

(n16)Footnote 16. *I.R.C. § 165(g)(3).*

(n17)Footnote 17. *See Treas. Reg. § 1.1001-1(g); see also Treas. Reg. § 1.1274-2(a); Rev. Rul. 89-122, 1989-2 C.B. 200 ; Rev. Rul. 79-292, 1979-2 C.B. 287 .*

(n18)Footnote 18. Installment reporting would not be available when either the new debt instrument or the old debt instrument was publicly traded. *I.R.C. § 453* contains a number of other important limitations.



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CHAPTER 9 Preparing for Chapter 11

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P 9.01 Introduction.

This final chapter in a book otherwise dedicated to the out-of-court aspects of business restructurings is a guide to preparation for a chapter 11 filing under the Bankruptcy Code. This chapter is included because an understanding of the preparation process and the factors relevant to deciding when and how to commence preparation for filing is essential for those involved in any workout. Throughout the workout process, the issue of whether an out-of-court restructuring is the proper course should be constantly revisited. At some point in the process, the company's decision-makers may decide that a chapter 11 filing is the better (or the only) option. Moreover, notwithstanding the company's view that a chapter 11 filing is undesirable or unnecessary, other stakeholders may reach a contrary conclusion and may file an involuntary chapter 11 petition. In anticipation of such a potential bankruptcy, the company involved in a workout may decide to begin preparation for a chapter 11 filing as a precautionary measure to ensure that filing is not prevented by the information gathering needed to file for bankruptcy and that an involuntary filing does not find the company unprepared.



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P 9.02 Scope and Use of This Chapter.

This chapter does not address the myriad of issues facing a debtor as it goes through the chapter 11 case. It outlines instead the many procedural and substantive legal and business questions that a debtor must address during the first hectic days of a chapter 11 case and describes how counsel can best help prepare the debtor prior to the filing to make the transition into chapter 11. Topics covered include when to begin filing preparation, where to file, which entities should file, what documentation is needed to place a company in chapter 11 and what substantive issues must be addressed on the first day to ensure the continued operations of the debtor. These issues include providing for the company's cash needs and handling certain concerns of employees, suppliers, governmental agencies and creditors.



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P 9.03 Why and When Should Preparation Begin?

Preparation for a chapter 11 filing can be expensive and should not be undertaken unnecessarily by a company that believes (and whose creditors and other stakeholders agree) that an out-of-court restructuring is a viable and beneficial option. While the filing of a chapter 11 petition for a small company can be accomplished quickly and with relatively little expense, chapter 11 preparation for a large company is time-consuming for company counsel and employees and costly. The extensive factual investigation, analysis and document preparation that should precede a filing may generate significant legal fees. The company may also incur substantial non-monetary costs if knowledge of the filing preparation becomes widespread in the company or among the public. Widespread knowledge within the company that chapter 11 preparation is underway may adversely affect employee morale, and the more widespread the knowledge within the company, the greater the risk of leaks to third parties and, thereby, of costly negative publicity.

Thorough preparation for a chapter 11 filing is, however, valuable to facilitate a smooth transition into and operation in chapter 11. Accordingly, preparation for a filing should commence at a point early enough to enable the debtor and its counsel and other advisors to analyze and accommodate the debtor's needs and to prepare the required filing papers. The prospective chapter 11 debtor and its counsel should, throughout the workout process, be on the alert for signs that preparation for a chapter 11 filing should be undertaken.

The debtor's cash position may be the single most important determining factor as to when preparation for a chapter 11 filing should commence. Insufficient cash to meet obligations or the need for new financing that is unavailable outside of chapter 11 would dictate the commencement of preparation by the debtor.ⁿ¹ Attempts by the debtor's creditors to foreclose on collateral, execute on judgments, attach assets of the estate or terminate valuable contracts or leases with the debtor will also necessitate preparation for an immediate chapter 11 filing.ⁿ²

The threat of an involuntary bankruptcy filing may also indicate that chapter 11 preparation should begin. The debtor and its counsel should recognize that the fact and timing of a bankruptcy filing are not necessarily within the control of the debtor. In appropriate circumstances, creditors may file an involuntary chapter 11 or chapter 7 petition against the debtor pursuant to 11 U.S.C. § 303.ⁿ³ If there is reason to believe that an involuntary petition may be filed, it often will be advisable for the debtor to begin its own filing preparation. Even if the debtor does not intend to commence a chapter 11 case, preparation would be advisable because of the advantages associated with a voluntary, as opposed to an involuntary, bankruptcy filing. For example, the debtor's choice of venue for its chapter 11 case can be valuable, as can its ability to control any publicity surrounding the filing.ⁿ⁴

Finally, a decision by the debtor that the attempted out-of-court restructuring has failed or will fail may, of course, also provide the impetus for commencing the filing preparationⁿ⁵ and may be advisable in light of directors' and officers' fiduciary duties.ⁿ⁶

FOOTNOTES:

(n1)Footnote 1. *See P 2.07 supra* regarding the effect of a chapter 11 filing on a debtor's cash flow and the availability of financing to the debtor.

(n2)Footnote 2. The filing of a petition operates as a stay of, among other things, the commencement or continuation of actions against the debtor based on prepetition claims, the enforcement against the debtor or property of the estate of judgments obtained before the filing of the petition, and any acts to obtain possession of property of the estate or to enforce liens against property of the estate. *See 11 U.S.C. § 362(a)*.

(n3)Footnote 3. *Section 104 of the Bankruptcy Code* provides for an automatic adjustment of dollar amounts in certain sections of the Bankruptcy Code, including section 303, every three years beginning April 1, 1998 in order to reflect inflation. The effective date of the most recent increase in dollar amounts pursuant to this section was April 1, 2007. In cases filed before April 1, 2007, the old amount (\$12,300) still applies.

Section 303(b) of the Bankruptcy Code, which was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 and which became effective on April 20, 2005, provides:

An involuntary case against a person is commenced by the filing with the bankruptcy court of a petition under chapter 7 or 11 of this title--

(1) by three or more entities, each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute as to liability or amount, or an indenture trustee representing such a holder, if such noncontingent, undisputed claims aggregate at least \$13,475 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims;

(2) if there are fewer than 12 such holders, excluding any employee or insider of such person and any transferee of a transfer that is voidable under section 544, 545, 547, 548, 549, or 724(a) of this title, by one or more of such holders that hold in the aggregate at least \$13,475 of such claims;

(3) if such person is a partnership--

(A) by fewer than all of the general partners in such partnership; or

(B) if relief has been ordered under this title with respect to all of the general partners in such partnership, by a general partner in such partnership, the trustee of such a general partner, or a holder of a claim against such partnership; or

(4) by a foreign representative of the estate in a foreign proceeding concerning such person.

11 U.S.C. § 303(b). If the involuntary petition is timely controverted, the bankruptcy court may order relief only if it determines 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 as to liability or amount); or (2) within 120 days before the date of the filing of the petition a custodian was appointed or took possession of the debtor's property. *11 U.S.C. § 303(h)*.

(n4)Footnote 4. *See PP 9.05 and 9.10[2] infra* for discussions of venue and publicity.

(n5)Footnote 5. *See ch. 2 supra*.

(n6)Footnote 6. *See ch. 3 supra*.



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P 9.04 Collecting Information.

Preparation for a chapter 11 filing involves extensive factual investigation on the part of the debtor and its counsel. Substantial amounts of information must be collected and disclosed in the required filing papers, schedules, statements and lists.ⁿ¹ Additionally, the determination of the relief that the debtor will require from the bankruptcy court in the early stages of its chapter 11 case can be made only if the debtor's counsel has a full understanding of the company's operations.ⁿ² Accordingly, when the decision is made to begin the preparation, the debtor's counsel should immediately take steps to familiarize itself with the debtor's operations and to obtain the necessary information. This task will require the substantial cooperation of and input from the debtor's employees.

As a means to understanding the company's circumstances, counsel should review the documents that reflect the debtor's corporate organization, financial position and business operations. The documents to be reviewed include the company's charter and by-laws, lists of subsidiaries, lists of major lenders, loan agreements, security agreements, debenture indentures, principal executory contracts and unexpired leases, lists of assets, recent financial statements, cash management agreements, employee benefit plan documents, lists of major suppliers, summaries of material litigation and public filings.ⁿ³ Further, counsel for the debtor should arrange to meet with the debtor's key employees to obtain any additional information that is needed.

A limited number of the debtor's employees should be identified to work on the preparation of the schedules, statements and lists that the debtor will be required to file in its chapter 11 case, and the information should be reviewed for accuracy by management. Those individuals should be advised of the applicable Bankruptcy Code and Federal Rules of Bankruptcy Procedure requirements and should be instructed as to the nature and extent of the information that must be collected and disclosed. As early as possible, employees should be assigned specific responsibilities and deadlines for the compilation of the data. As illustrated below, early commencement of the schedule preparation is desirable because of the magnitude of the projectⁿ⁴ and the possibility that the debtor will lose employees who possess important knowledge.

Counsel for the debtor should be sensitive to the fact that the debtor's employees may be reluctant to disclose information to the public and even to the debtor's own lawyers. Furthermore, in light of the company's situation, it would not be surprising to find the debtor's employees reluctant to engage energetically in a review of the company's files. Counsel should advise the debtor's employees of the consequences of a failure to disclose information in the required schedules, including an erosion in confidence in the debtor's competence and truthfulnessⁿ⁵ and risk to the

officer who must sign the debtor's schedules.ⁿ⁶ Additionally, with respect to disclosure of information to the lawyers themselves, counsel should explain that full cooperation is necessary to ensure, among other things, that the debtor's operations remain undisrupted by a failure to seek necessary first-day relief from the bankruptcy court.

FOOTNOTES:

(n1)Footnote 1. *See P 9.07 infra* for a discussion of the preparation of the filing papers.

(n2)Footnote 2. *See P 9.08 infra* for a discussion of first-day motions.

(n3)Footnote 3. If the debtor has been involved in an attempted out-of-court restructuring, counsel will likely already have reviewed these documents. *See ch. 2 supra*.

(n4)Footnote 4. In certain cases, the task will be complicated by poor record-keeping on the part of the debtor.

(n5)Footnote 5. Furthermore, the failure to file complete schedules may justify the conversion of a case under chapter 11 to a case under chapter 7 or the dismissal of the chapter 11 case. *See 11 U.S.C. § 1112(e)*.

(n6)Footnote 6. *See, e.g.*, Official Form 2 ("Declaration Under Penalty of Perjury on Behalf of a Corporation or Partnership"), available at www.uscourts.gov/bkforms/official/b2.pdf *reprinted in* Vol. A., Collier on Bankruptcy, App. Pt. 2(d) and Vol. 11 Collier on Bankruptcy, Pt. 8 Form No. 8.02-2 (Matthew Bender 15th Ed. Revised).



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P 9.05 Venue.

As one of the essential steps in preparation for a bankruptcy filing, the debtor must determine in which district it wishes to file its chapter 11 petition. Counsel should advise the debtor of the legal restrictions and practical considerations relating to the debtor's venue decision. The venue choice may affect the relief a debtor may be granted. For a variety of reasons, the District of Delaware and the Southern District of New York remain the most popular venues for large chapter 11 cases.

[1] Legal Restrictions.

Initial choice of venue in a bankruptcy case is controlled by 28 U.S.C. section 1408.ⁿ¹ The debtor may choose to file its petition in the district in which the debtor's domicile, residence, principal place of business in the United States, or principal assets in the United States have been located for the 180 days immediately preceding the filing, or have been located for the longer portion of such 180-day period than in any other district.ⁿ²

If an affiliate,ⁿ³ general partner or partnership of the debtor has already filed a chapter 11 petition, the debtor may elect to file its own petition in the district where the case concerning the affiliate, general partner or partnership is pending.ⁿ⁴

[2] Practical Considerations.

Venue may be proper in several districts, leaving the debtor with a choice of locations in which its chapter 11 case may be commenced. Once the possible districts have been identified, the debtor and its counsel should evaluate the options in light of a number of practical considerations. Among those considerations are: (i) the location of the districts *vis-a-vis* the location of the debtor, its counsel and its major creditors; (ii) the districts' local rules and practices and their interpretations of substantive law; (iii) the districts' orientations, experience with similar cases and docket status; and (iv) the debtor's ability to retain qualified counsel to represent it in the districts.

[a] Physical Location.

The debtor should consider the proximity of the districts to its principal place of operations, its attorneys and its major creditors. Frequently, the debtor will find it advantageous to file in a district near its principal place of operations. Because a bankruptcy case can involve frequent court appearances by the debtor's personnel and management, the debtor may decrease its administrative costs and lessen the number of interruptions in its operations if it files in a nearby

district. In addition, a bankruptcy court in the debtor's home district may be more sympathetic to and cooperative with a business that provides employment to many of the area's citizens. The debtor may, however, wish to avoid filing near its principal place of business if it is afraid that negative publicity could adversely affect its operations. The debtor's local media is likely to provide more extensive coverage of the bankruptcy filing if it occurs in a nearby district.

The debtor also should consider the location of the districts in relation to that of the debtor's counsel. Counsel's proximity to the court obviously will decrease the administrative costs to the estate. Moreover, to the extent that counsel's local court is chosen, the estate may benefit from the attorneys' greater familiarity with the local procedures, interpretations of substantive law and propensities of the judges.

Finally, the location of the debtor's major creditors may be significant. If a particular venue is inconvenient for the major creditors, they may be more likely to seek a change of venue, especially if the venue is not the debtor's home district.ⁿ⁵

[b] Local Rules, Practice, and Substantive Law.

The relevant substantive law, procedural rules and practices of each of the potential venues should also be considered. In particular, counsel should focus on any interdistrict differences in the interpretation of the substantive law governing issues that may directly affect the debtor's case, including fraudulent conveyances, equitable subordination, the automatic stay, adequate protection and the ordinary course of business standard and payments to critical vendors. Counsel should also review the local rules and practices of the courts, focusing on differences that may affect the length or cost of the case. Additionally, the attitudes and practices of the United States trustees in the various districts should be considered.ⁿ⁶

[c] Orientation, Experience, and Docket Status.

A given district's "pro-debtor" or "pro-creditor" orientation might be considered relevant to the venue decision. In most cases, it will not be the determining factor, however, and it often will be impossible to predict whether the debtor will end up before a judge whose views will favor the debtor's positions. More important are the courts' experience and familiarity with chapter 11 cases of similar nature, size and complexity, and the status of the courts' dockets. The fact that a court is familiar with the operation of businesses like the debtor's and the problems they experience in chapter 11 may be reason to file in that district. Moreover, with respect to venue decisions in complex cases, the extent of a court's experience with large chapter 11 cases may be relevant. Attention should also be paid to the status of the relevant courts' dockets. Backlog in a court's docket may affect that court's ability to give prompt attention to matters that are important to the debtor.ⁿ⁷

A related consideration might be the availability of certain types of first-day relief in the districts under consideration. Particularly when a debtor will require relief that goes beyond purely administrative matters, a review of the courts' historical responses to such requests is advisable.

[d] Obtaining Counsel.

The debtor's selection of counsel or other professionals also may influence its venue choice. Some attorneys may prefer not to represent debtors in certain jurisdictions for a variety of reasons, including the local practice regarding the allowance and time of payment of attorneys' fees.ⁿ⁸ Practices may also differ among districts as to the terms on which investment bankers and financial advisors may be retained.

FOOTNOTES:

(n1)Footnote 1. Venue of cases ancillary to foreign proceedings is governed by 28 U.S.C. § 1410, which was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), and which

became effective on April 20, 2005. Change of venue is governed by 28 U.S.C. § 1412 and Bankruptcy Rule 1014.

(n2)Footnote 2. 28 U.S.C. § 1408(1).

(n3)Footnote 3. "Affiliate" is defined in section 101 of the Bankruptcy Code as:

(A) entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities--

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(B) corporation 20 percent or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by the debtor, or by an entity that directly or indirectly owns, controls, or holds with power to vote, 20 percent or more of the outstanding voting securities of the debtor, other than an entity that holds such securities--

(i) in a fiduciary or agency capacity without sole discretionary power to vote such securities; or

(ii) solely to secure a debt, if such entity has not in fact exercised such power to vote;

(C) person whose business is operated under a lease or operating agreement by a debtor, or person substantially all of whose property is operated under an operating agreement with the debtor; or

(D) entity that operates the business or substantially all of the property of the debtor under a lease or operating agreement.

11 U.S.C. § 101(2).

(n4)Footnote 4. 28 U.S.C. § 1408(2).

(n5)Footnote 5. 28 U.S.C. § 1412 provides that "[a] district court may transfer a case or proceeding under title 11 to a district court for another district, in the interest of justice or for the convenience of the parties." *Fed. R. Bankr. P. 1014* grants bankruptcy courts similar authority.

(n6)Footnote 6. See P 9.09 *infra* for a discussion of the role of the United States trustee.

(n7)Footnote 7. See L. LoPucki, *Courting Failure: How Competition for Big Cases is Corrupting the Bankruptcy Courts* for one scholar's opinion on venue selection, Univ. of Mich. Press 2005 ISBN 047244867.

(n8)Footnote 8. Some districts have published guidelines governing professional compensation. See, e.g., Amended Guidelines for Fees and Disbursements for Professionals in Southern District of New York Bankruptcy Cases available at <http://www.nysb.uscourts.gov/orders/m150.pdf>; Delaware Bankruptcy Courts General Chambers Procedures Sections 7(h)-(i) available at http://www.deb.uscourts.gov/Chambers/general_procedures.pdf; and Northern Dist. Of Illinois Local Rule 5082-1 available at http://www.ilnb.uscourts.gov/Rules_Orders_Procedures/Local_Rules_2008.pdf



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P 9.06 Affiliate Filings.

Each member of a corporate group need not seek protection under the Bankruptcy Code simply because one member of the group is filing a chapter 11 petition. Indeed, it may not be desirable for every affiliated entity of the debtor to file. As a general rule, each affiliated entity should first independently determine whether it requires or would benefit from the protection afforded under chapter 11 by considering the same factors that influenced the original debtor's decision to file. A chapter 11 case may be expensive, may subject the entity to intense scrutiny by the court and otherwise restrict its ability to operate its business independently. A chapter 11 filing will be useful only for those entities which, in light of the nature of their assets and debts, need the protection afforded by the automatic stay and other provisions of the Bankruptcy Code.ⁿ¹

The relationship among the affiliates may, however, make it necessary for an affiliate to file for chapter 11 relief. In particular, certain intercompany transactions between the debtor and its affiliates may necessitate the affiliates' filing. If, for example, an affiliate has guaranteed a large portion of the debtor's debts, it may need to file a chapter 11 petition even though its operations do not reflect financial difficulties. The automatic stay provided by *section 362 of the Bankruptcy Code* does not protect a non-debtor guarantor of the debts of the debtor.ⁿ² A creditor, finding its actions stayed against the debtor, may accelerate the debt and the guarantor's obligations and may foreclose on any assets securing the guarantees. The affiliate should therefore consider filing its own petition if the accelerated debt will impose too heavy a financial burden on it.ⁿ³

The affiliate should also analyze its ability to survive without whatever financial support the debtor provides. Once the case commences, the court may not permit the debtor to continue its financing of affiliates. After investigating the possibility of other sources of financial and management support, the affiliate can determine whether the debtor's bankruptcy so weakens the affiliate's financial status as to dictate its own filing of a chapter 11 petition.

While certain circumstances may dictate that an affiliate file for bankruptcy protection because of its relationship with the debtor, other circumstances may militate against an affiliate's filing. For example, a situation in which the bankruptcy filing of the debtor's affiliate will trigger a contingent liability for which the debtor is jointly and severally liable may make the affiliate's filing inadvisable.ⁿ⁴

FOOTNOTES:

(n1)Footnote 1. If bankruptcy petitions for two or more affiliated companies (or a partnership and one or more of its

general partners) will be filed, the debtor and its counsel should consider the possibility of joint administration of the cases. If joint administration is desired, counsel should prepare the appropriate motion papers. *See P 9.08[4] infra* for a discussion of joint administration motions.

(n2)Footnote 2. *See 11 U.S.C. § 362.*

(n3)Footnote 3. Similarly, because the automatic stay does not protect the co-defendant of a chapter 11 debtor, if a material claim had been asserted against the debtor and an affiliate seeking to hold them jointly and severally liable, the otherwise healthy affiliate might consider filing its own petition. *See 1 Collier Bankruptcy Practice Guide, P 4.02[2]* (Matthew Bender).

The general partners of a partnership filing a bankruptcy petition should also consider filing individual petitions because they will be liable for partnership debts. The automatic stay does not protect the general partners of a filing partnership. *See 3 Collier on Bankruptcy, P 362.03[3][d]* (Matthew Bender 15th Ed. Revised).

(n4)Footnote 4. *See 1 Collier Bankruptcy Practice Guide, P 4.02[2]* (Matthew Bender). For example, withdrawal liability under multi-employer qualified pension plans imposed by ERISA should be considered.



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P 9.07 Preparation of the Filing Papers.

Prior to the commencement of any chapter 11 case, certain preparatory activities must be undertaken. Regardless of how much time is available, the debtor and its counsel must prepare the basic filing papers required by the Bankruptcy Code, the Federal Rules of Bankruptcy Procedure¹ and the local rules of the bankruptcy court in which the case will be commenced.² To the extent that time allows, the debtor and its counsel should undertake the preparation of the extensive schedules, statements and lists required of a chapter 11 debtor.

[1] Petition.

A voluntary chapter 11 case is commenced by filing a petition under chapter 11 with the clerk of the bankruptcy court.³ If no bankruptcy clerk has been appointed for a particular judicial district, the petition should be filed with the clerk of the district court.⁴

The petition should be prepared as prescribed by Official Form 1.⁵ In the case of a corporate debtor required to file periodic reports with the Securities and Exchange Commission, the official form for the petition includes Exhibit A, in which the debtor must, among other things, disclose summary financial data, briefly describe its business, identify any person who directly or indirectly owns, controls or holds, with power to vote, 5% or more of the voting securities of the debtor. Exhibit A is included as a means of supplying the Securities and Exchange Commission with the information it needs in the early stages of a chapter 11 case to determine how actively it should monitor the case.⁶

The petition must be verified by the debtor or contain an unsworn declaration under penalty of perjury as provided in 28 U.S.C. section 1746.⁷ The unsworn declaration for a corporate or partnership debtor is incorporated into Official Form 1 and may be signed on behalf of a corporation by an officer or authorized agent of the corporation, or on behalf of a partnership by a general partner or authorized agent of the partnership. If a debtor is represented by counsel, the attorney also must sign the petition.⁸ Only the original petition need be signed and verified but all copies must conform to the original.⁹ The number of copies of the petition that must be filed is a matter governed by the local bankruptcy rules of the court in which the petition is filed.¹⁰

[2] Certificate of Corporate or Partnership Authority.

The filing of a bankruptcy petition must be authorized. In the absence of proper authorization, the court lacks jurisdiction over the chapter 11 case and the protections of the Bankruptcy Code are unavailable to the debtor.¹¹ Of

particular significance is the fact that actions taken against the debtor, which would have been prohibited by the automatic stay, will be valid. Accordingly, obtaining and evidencing proper authorization for the chapter 11 filing is essential.

[a] Corporate Debtors.

State law generally gives a corporation's board of directors the authority to make the decision to file the corporation's chapter 11 petition.ⁿ¹² The corporation's governing documents may, however, impose limitations on the ability of the board of directors to make that decision and accordingly, such documents should be consulted. Additionally, review of the corporate charter and by-laws is necessary to determine the appropriate mechanism for obtaining the board's authorization. Specifically, provisions relating to the convening of a special meeting of the board must be reviewed with particular attention to requirements relating to notice, quorum, voting and any other procedural issues connected with the special meeting.ⁿ¹³

The board resolutions authorizing the bankruptcy filing should identify: (i) the chapter of title 11 under which the petition will be filed; (ii) the court in which the petition will be filed; and (iii) the officers authorized to execute and file the petition.ⁿ¹⁴ Additionally, the resolutions should authorize the debtor to retain bankruptcy counsel, preferably identifying the specific counsel to be retained.ⁿ¹⁵ Furthermore, to the extent possible, the resolutions should authorize any special actions requiring board approval that the corporation will need to take upon the commencement of the bankruptcy case or soon thereafter.ⁿ¹⁶ For example, if the debtor will open new debtor-in-possession bank accounts or obtain new financing, the board should adopt resolutions authorizing such actions.

A corporate debtor's chapter 11 petition should be accompanied by a copy of the board's resolution authorizing the filing.ⁿ¹⁷ Indeed, the local bankruptcy rules of certain districts specifically require the filing of the board resolution. Pursuant to *Federal Rules of Bankruptcy Procedure* 1007(a)(1) and 7007.1(a), the debtor's petition should also be accompanied by a statement identifying any corporation that owns, directly or indirectly, 10% or more of the debtor.ⁿ¹⁸

[b] Partnership Debtors.

With respect to partnership debtors, the issue of authority to file a bankruptcy petition is specifically addressed by the Bankruptcy Code. Pursuant to section 303(b)(3)(A), all general partners must consent to the filing of a bankruptcy petition on behalf of the partnership, or the court will treat the petition as an involuntary petition.ⁿ¹⁹ State law, the partnership agreement or the partnership certificate may provide that the consent of the limited partners is also required and may dictate the mechanics of obtaining the requisite consents.ⁿ²⁰

Obtaining the required consents may be time-consuming and the process should be initiated early in the preparation period. Counsel may need to seek consents on several levels. For example, if one of the general partners is a corporation, counsel will need to ensure that the corporation convenes a special meeting of the board of directors to adopt the resolutions necessary to authorize an officer of the corporation to consent on behalf of the corporation, in its role as general partner, to the partnership's chapter 11 filing.

Once all the necessary consents have been obtained, any partner may actually execute and file the petition.ⁿ²¹ Written evidence of the other general partners' consents to the filing should be attached to the chapter 11 petition.ⁿ²²

[3] Local Rule Requirements.

The local rules of the bankruptcy court in which the debtor will file its chapter 11 petition may impose filing requirements that supplement those imposed by the Bankruptcy Code and Federal Rules of Bankruptcy Procedure. For example, the local rules may require the debtor to submit an affidavit describing the debtor's business and financial positionⁿ²³ and, as discussed above, may require the filing of a corporate resolution authorizing the commencement of

the bankruptcy case.ⁿ²⁴ Accordingly, counsel for the debtor should review the local rules of the relevant court to ascertain the applicable filing requirements.

[4] Filing Fee.

The filing fee applicable in a chapter 11 case is governed by *28 U.S.C. section 1930*. In a case commenced under chapter 11 (that does not concern a railroad), the party commencing the case must pay to the clerk of the bankruptcy court a filing fee in the amount of \$1,000.ⁿ²⁵ The clerk may have specific requirements relating to payment of the filing fee (e.g., requiring that any payment made by the debtor be in the form of a certified check). To avoid problems on the date of filing, the existence of any such requirements should be determined in advance by inquiring of the clerk's office.

[5] Federal Rule Of Bankruptcy Procedure 2016 Statement.

Federal Rule of Bankruptcy Procedure 2016(b) requires every attorney for the debtor (whether or not the attorney applies to the court for compensation) to file with the court and transmit to the United States trustee, within 15 days after the filing of the petition, the disclosure of compensation statement required by *section 329 of the Bankruptcy Code*.ⁿ²⁶ Pursuant to section 329, the attorney must file:

a statement of the compensation paid or agreed to be paid, if such payment or agreement was made after one year before the date of the filing of the petition, for services rendered or to be rendered in contemplation of or in connection with the case by such attorney, and the source of such compensation.ⁿ²⁷

Under *Federal Rule of Bankruptcy Procedure 2016(b)*, the statement must disclose whether the attorney has shared or agreed to share the compensation with any other entity.ⁿ²⁸ It is advisable for any attorney that the debtor will seek to retain on the first day of the chapter 11 case to file the statement pursuant to *Federal Rule of Bankruptcy Procedure 2016* simultaneously with the filing of the debtor's petition and the application for approval of retention of counsel.

Rule 2016(c) requires a declaration to be filed by the bankruptcy petition preparer within ten days of filing which discloses payments made within twelve months and all unpaid fees to the debtor.

[6] Schedules, Statements, and Lists.

A chapter 11 debtor is required to file with the bankruptcy court detailed schedules, statements and lists.ⁿ²⁹ Pursuant to the Bankruptcy Rules, certain of those documents must be filed with the petition, while the others must be filed within a short time thereafter, absent a court order extending the relevant deadlines.ⁿ³⁰ The number of copies of the documents required to be filed is determined by reference to the local bankruptcy rules of each court.ⁿ³¹

As illustrated below, the preparation of the required schedules, statements and lists can be extremely time-consuming and complicated for a large corporate debtor. Considerable information must be collected, reviewed and organized by the debtor and its counsel and the information must be packaged in a form suitable for filing with the court. Because an officer or agent of the corporate debtorsⁿ³² must declare, under penalty of perjury, that the information contained in the schedules, statements and lists is true and correct to the best of his or her knowledge, information and belief, thoroughness and accuracy in the preparation of the schedules are essential.

The debtor and its counsel should determine the most cost-effective method for the physical production of the schedules. Computer software geared to the needs of chapter 11 debtors is available and can be useful in the schedule preparation process.ⁿ³³ Moreover, particularly with respect to the preparation of lengthy creditor lists and schedules of liabilities, the retention of an outside data-processing/noticing service may be advisable.ⁿ³⁴

[a] Creditor Lists.

The debtor is required to file a list of the creditors, excluding insiders, who hold the 20 largest unsecured claims against the debtor.ⁿ³⁵ This list enables the United States trustee to appoint a committee of unsecured creditors pursuant to *section 1102 of the Bankruptcy Code*.ⁿ³⁶ The list should be prepared as prescribed by Official Form 4, stating the name, telephone number and address of each creditor (and information about employees, agents or departments of the creditor familiar with the claim), the nature and value of the claim and the value of any security, and indicating if the claim is contingent, unliquidated or disputed or subject to setoff.ⁿ³⁷ The list must be verified or contain an unsworn declaration in the form prescribed by Official Form 2,ⁿ³⁸ and must be filed with the petition.ⁿ³⁹

The debtor also is required to file with its petition a full list of its creditors if the petition is not accompanied by a schedule of the debtor's liabilities.ⁿ⁴⁰ The deadline for filing the creditor list can be extended only on motion for cause shown and on notice to the United States trustee and to any trustee, committee or other party as the court might direct.ⁿ⁴¹ This list is essential in order to give creditors notice of the chapter 11 filing, as required by *section 342 of the Code*.

The local rules of the bankruptcy court may impose additional requirements relating to the filing of creditor lists. The rules of many courts prescribe the form that the debtor's full creditor list should take. Such rules often require that a matrix list be provided or, when a case involves numerous creditors, the rules may mandate that the list be filed along with a disk (or other electronic format) to facilitate electronic mailings to creditors.ⁿ⁴² Additionally, the local rules may require the debtor to file a creditor list even when the Federal Rules of Bankruptcy Procedure do not require such a filing.ⁿ⁴³

In large cases, the debtor may seek to retain the services of an outside claims agent to produce and mail (or otherwise deliver) all notices to creditors.ⁿ⁴⁴ If such a retention will be sought, the debtor should consider seeking a waiver of those local rule requirements relating to the form of the creditor list that are designed to facilitate mailing by the clerk's office of creditor notices.

Because the creditor list defines the universe of those who will receive personal notice of the claims bar date and the meeting of creditors, the debtor should list all individuals and entities who might have claims against the estate. Counsel should advise the debtor to err on the side of overinclusion, emphasizing that the creditor list should not be limited to those individuals or entities known by the debtor to have claims against the estate. The debtor should be informed that the creditor list should include all entities holding contingent liabilities.

Although no Bankruptcy Code provision or Federal Rule of Bankruptcy Procedure sets forth guidelines for the preparation of the creditor list, the debtor should, as a general rule, include all individuals employed by the debtor for at least the two years preceding the filing, all vendors and landlords paid by the debtor during that period, all taxing authorities with which the debtor has filed returns for the several years preceding the filing, all parties to executory contracts with the debtor, all persons with lawsuits pending against the debtor, all beneficiaries of the debtor's employee benefit programs, and any other individual or entity whose relationship with the debtor might give rise to a claim against the estate.

[b] List of Equity Security Holders.

Pursuant to *Federal Rule of Bankruptcy Procedure 1007(a)(3)*, the debtor is required to file a list of its equity security holders of each class, as of the petition filing date, showing the number and kind of interests registered in the name of each holder and the holder's last known address or place of business.ⁿ⁴⁵ The list of equity security holders must be filed within 15 days of the filing of the petition unless the court extends the deadline upon motion for cause shown with notice to the United States trustee and to any trustee, committee or any other party as the court might direct.ⁿ⁴⁶

The preparation of the list of equity security holders should not be difficult for most closely-held companies. However,

for a public company, the compilation of the list can be time-consuming and difficult, requiring the debtor's corporate secretary to work in conjunction with transfer agents.ⁿ⁴⁷

Pursuant to *Federal Rule of Bankruptcy Procedure 1007(i)*, the bankruptcy court, "[a]fter notice and hearing and for cause shown," may direct a third party to disclose any list of security holders of the debtor that is in its possession or under its control which indicates the name, address and security held by any of the security holders.ⁿ⁴⁸ Upon the motion of a party in interest and "for cause shown," the court may direct that any of the lists filed under *Rule 1007*, including the list of equity security holders, be impounded and may refuse to permit inspection of the lists by any entity.ⁿ⁴⁹

[c] Schedules and Statements.

In addition to the lists described above, the debtor is required to file schedules of assets and liabilities, a schedule of current income and expenditures, a schedule of executory contracts and unexpired leases and a statement of financial affairs.ⁿ⁵⁰ *Federal Rule of Bankruptcy Procedure 1007(c)* provides that "[i]n a voluntary case, the schedules and statements, ... shall be filed with the petition within 15 days thereafter."ⁿ⁵¹

The debtor must provide a considerable amount of information in the schedules and statements. It often will be difficult, if not impossible, for a debtor of substantial size to meet the deadline for the filing of the schedules. Accordingly, the Bankruptcy Rules provide for an extension of time for filing the schedules and statements but "only on motion for cause shown and on notice to the United States trustee and to any committee elected pursuant to § 705 or appointed pursuant to § 1102 of the Code, trustee, examiner, or other party as the court may direct."ⁿ⁵² In a large case, the bankruptcy court can be expected to grant an extension. Further extensions should not necessarily be expected, however.

In preparing for the chapter 11 filing, an assessment should be made as to whether an extension of the filing deadline for the schedules and statements is needed and, if so, appropriate motion papers should be prepared for filing on the first day.ⁿ⁵³ Even if an extension will be sought, however, it is advisable to begin the work of gathering the necessary information early in the prefiling period.

[i] Schedules.

Official Form 6 is a compilation of the schedules that the debtor is required to file. As amended in 2005, the schedules included in the Official Form are the various component schedules of the debtor's assets and liabilities, a schedule identifying any codebtors on claims against the debtor, a schedule identifying community liability for the claims, a schedule of the debtor's executory contracts and unexpired leases, and, for individual debtors, schedules of current income and current expenditures. The Official Form does not include schedules for the current income and expenditures of corporate and partnership debtors and, accordingly, such debtors will need to prepare those schedules without the guidance of an Official Form.

As part of Official Form 6, the debtor must complete a Summary of Schedules, indicating, as to each schedule, whether the schedule is attached and the number of pages in the schedule. The debtor also must report the totals from several of the schedules included in the Official Form and must calculate the sums of the debtor's assets and liabilities. The Official Form includes an unsworn declaration to be signed by an officer or other agent of a corporate debtor or a member or authorized agent of a partnership debtor. The preparation of the individual schedules is discussed below.

[A] Schedules of Assets and Liabilities.

The schedules of assets and liabilities should be prepared as prescribed in Schedules A-F of Official Form 6.ⁿ⁵⁴ Schedules A, B and C are the components of the schedule of assets. Together, they itemize all property of the debtor as of the date of the chapter 11 filing.

Schedule A lists all of the debtor's interests in real property.ⁿ⁵⁵ The debtor must provide a description of the real property and its location, a statement of the nature of the debtor's interest in the property, and a statement of the current value of the interest (without deduction for secured claims) and of the amount of any secured claims on the property. Schedule B lists all personal property of the debtor, including a description of the property and its location, and a statement of the value of the debtor's interest without deduction for secured claims. Schedule C, to be filed only by an individual debtor, lists property claimed as exempt by the debtor.ⁿ⁵⁶

Schedules D, E and F of Official Form 6 comprise the schedule of liabilities.ⁿ⁵⁷ Together they itemize all claims against the debtor or the debtor's property as of the date of the filing of the petition.

Schedule D lists all creditors holding security interests of any type in property of the estate. The debtor must provide the name and address of each secured claimant, indicate whether there is a codebtor on the claim, specify the date the claim was incurred and the nature of the lien, describe the property subject to the lien and state its market value, indicate if the claim is contingent, unliquidated or disputed,ⁿ⁵⁸ and state the amount of the claim without deducting the value of the collateral.ⁿ⁵⁹

Schedule E lists all debts incurred before the chapter 11 filing that would be entitled to priority under *Bankruptcy Code section 507*.ⁿ⁶⁰ The schedule should include all claims entitled to priority, separating the claims by type of priority, and stating the name and address of the creditor, indicating if there is a codebtor, stating the date the claim was incurred and the consideration therefor, indicating if the claim is contingent, unliquidated or disputed, and stating the total amount of the claim and the amount entitled to priority.

Schedule F lists all creditors having unsecured claims without priority. The debtor must list each claim, stating the name and address of the creditor,ⁿ⁶¹ indicating if there is a codebtor on the claim, specifying when the claim was incurred and the consideration therefor, indicating if the claim is subject to setoff, specifying if the claim is contingent, unliquidated or disputed, and stating the amount of the claim.ⁿ⁶²

[B] Schedule of Executory Contracts and Unexpired Leases.

The debtor is required to file a schedule of its executory contracts and unexpired leases.ⁿ⁶³ The schedule should be prepared as prescribed in Schedule G of Official Form 6. The schedule should include all executory contracts and unexpired leases to which the debtor is a party, and should provide the name and address of the other party (or parties) to the contract or lease and a description of the contract or lease and of the nature of the debtor's interest in the contract.ⁿ⁶⁴

A large corporate debtor is likely to be a party to numerous executory contracts and unexpired leases, falling within the domain of various departments in the company, and compilation of the schedule of executory contracts may require the substantial efforts of numerous employees. Therefore, even if an extension of the filing deadline will be sought, the collection of all executory contracts and unexpired leases and the preparation of the schedule should begin as early as possible, preferably in the prefiling period.ⁿ⁶⁵

The early collection and review of the debtor's executory contracts and unexpired leases is important for another reason as well. Pursuant to *section 365 of the Bankruptcy Code*, "the trustee [or debtor in possession], subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor," with certain exceptions enumerated in the statute.ⁿ⁶⁶ While the debtor may assume or reject an executory contract or an unexpired lease of residential real property or of personal property at any time before confirmation of a plan,ⁿ⁶⁷ the debtor has only 120 days from the date of its chapter 11 filing to assume or reject an unexpired lease of nonresidential real property under which the debtor is the lessee.ⁿ⁶⁸ If the debtor does not assume or reject such a lease within the initial 120 days, or does not obtain a one-time 90-day extension from the court or a further extension with the landlord's written consent, then the

lease is deemed rejected and the debtor must immediately surrender the premises.ⁿ⁶⁹

Clearly, a "deemed" rejection can have serious adverse consequences for the debtor if the property is essential to the debtor's continued operations and reorganization effort. For that reason, an analysis of all non-residential real property leases should be conducted as early as possible to enable the debtor to protect any interests of value it holds in such leases. Furthermore, early determination by the debtor that such leases should be rejected can preserve assets of the estate. If the debtor will reject an unexpired lease of nonresidential real property, the rejection should be accomplished as early as possible to avoid the accrual of administrative priority expenses.ⁿ⁷⁰ Even if the debtor is not prepared to assume or reject unexpired leases of non-residential real property in the first 120 days of the case, it must seek a 90-day extension of the deadline within the allotted 120-day period because any subsequent extensions may be granted only upon the lessor's prior written consent.ⁿ⁷¹

The assumption or rejection of contracts or leases other than unexpired leases of non-residential real property generally is not a pressing item for the debtor. While early rejection of contracts can, for example, prevent the extension of the bar date for filing of claims resulting from the rejection of the contracts, the debtor will not suffer significant harm from its failure to assume or reject such contracts early in the case.ⁿ⁷²

[C] Schedule of Codebtors.

Schedule H of Official Form 6 requires the debtor to provide the name and address of any person or entity that is liable with the debtor on any debts listed in the debtor's schedules of liabilities, including guarantors and cosigners. The Schedule of Codebtors is not specifically required by *section 521 of the Bankruptcy Code* or *Federal Rule of Bankruptcy Procedure 1007*.

[D] Schedule of Current Income and Expenditures.

The debtor must file a schedule of current income and expenditures.ⁿ⁷³ No official form for the schedule is prescribed for partnerships and corporations, but a statement showing the estimated cash receipts and disbursements in the month following the filing should suffice.

[ii] Statement of Financial Affairs.

The chapter 11 debtor must also file a Statement of Financial Affairs, prepared in the question/answer format as prescribed by Official Form 7.ⁿ⁷⁴ All debtors must complete Questions 1-18 of the Statement of Financial Affairs. Debtors that are or have been engaged in business also must complete Questions 19-25. The Official Form for the Statement contains an unsworn declaration.

[d] Reservation of Rights.

While every effort should be made to ensure that all designations in the schedules and statements are accurate, the complexity of the debtor's business, the possibly disorganized or inadequate state of the debtor's records, and the compressed time period in which the schedules and statements will be prepared may lead to inaccuracies. Accordingly, the debtor should expressly reserve its right to correct any inaccuracies. This is particularly important with respect to the schedule of liabilities, to which a statement should be added to the effect that a failure to designate an amount on the schedule as contingent, unliquidated or disputed does not constitute an admission that such sum is not subject to objection. The debtor should also expressly reserve its right to dispute or assert offsets or defenses to any claim as to amount, liability or status.ⁿ⁷⁵

FOOTNOTES:

(n1)Footnote 1. The Federal Rules of Bankruptcy Procedure and Official Forms govern procedure in cases under title 11 of the United States Code. *See Fed. R. Bankr. P. 1001*.

(n2)Footnote 2. The local bankruptcy rules for each judicial district are compiled in the Collier Bankruptcy Practice Guide Local Rules Pamphlets (Matthew Bender).

(n3)Footnote 3. *Section 301 of the Bankruptcy Code* provides: "[a] voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition under such chapter by an entity that may be a debtor under such chapter." *11 U.S.C. § 301(a)*; *see also Fed R. Bankr. P. 1002*. Section 109 specifies the types of debtors that are eligible for relief under each chapter of title 11. *See 11 U.S.C. § 109*.

(n4)Footnote 4. 1987 Advisory Committee Note to Bankruptcy Rule 1002.

(n5)Footnote 5. The Official Forms have been revised several times, most recently December 2008 to reflect the changes made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005). The Advisory Committee on Bankruptcy Rules has prepared and has recommended for local court adoption Interim Rules designed to implement changes made by the 2005 amendments to the bankruptcy laws (Pub. Law No. 109-8). The Interim Rules are intended to apply until the Federal Rules of Bankruptcy Procedure are amended to implement the 2005 amendments. The Interim Rules are effective only in cases commenced on or after October 17, 2005, and only in the judicial districts that have adopted them by local rule or court order.

Bankruptcy Rule 5005(a) states that the clerk "shall not refuse to accept for filing any petition or other paper presented for the purpose of filing solely because it is not presented in proper form as required by these rules or any local rules or practices." *Fed. R. Bankr. P. 5005(a)*. However, the court itself may disregard papers if they do not substantially comply with the applicable rules.

Fed. R. Bankr. P. 9009 provides that the Official Forms "shall be observed and used with alterations as may be appropriate" in cases and proceedings under the Bankruptcy Code. "[T]he use of the Official Forms has been held to be subject to a 'rule of substantial compliance.'" Introduction and General Instructions to Federal Rules of Bankruptcy Procedure and Official Bankruptcy Forms. As a general rule, the inclusion of all information required by the official form in a format chosen by the debtor is deemed to satisfy the "substantial compliance" test. *See id.* However, the format of Form 1, the Voluntary Petition (as amended in 2008) is now prescribed. *Id.*

In addition, the petition, schedules and statements of financial affairs (Official Forms 1, 5, 6 and 7) must be "printed on one side of the paper only. Each page is to be pre-punched with two holes at the top, and sufficient top margin allowed so that neither caption nor text is destroyed or obscured." *Id.*

If the debtor intends to use computer-generated forms, the Introduction and General Instructions to the Revised Official Bankruptcy Forms should be consulted with respect to other formatting requirements. Many districts now require that documents be filed electronically. The local court rules should be consulted in this regard.

(n6)Footnote 6. *See* 1991 Advisory Committee Note to Official Form 1, available at www.uscourts.gov/bkforms/bankruptcy-forms.html, *reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 2(d) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. *Fed. R. Bankr. P. 1008*. Except when specifically provided in the Federal Rules of Bankruptcy Procedure, papers filed in a case under the Bankruptcy Code need not be verified. When verification is required by the Rules, as is the case with a voluntary chapter 11 petition, an unsworn declaration satisfies the requirement. *See Fed. R. Bankr. P. 9011(e)*.

(n8)Footnote 8. *Fed. R. Bankr. P. 9011(a)* provides, in part:

(a) *Signature*. Every petition, pleading, written motion, and other paper, except a list, schedule, or statement, or amendments thereto, shall be signed by at least one attorney of record in the attorney's

individual name. A party who is not represented by an attorney shall sign all papers. Each paper shall state the signer's address and telephone number, if any. An unsigned paper shall be stricken unless omission of the signature is corrected promptly after being called to the attention of the attorney or party.

(b) *Representations to the Court.* By presenting to the court (whether by signing, filing, submitting, or later advocating) a petition, pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief, formed after an inquiry reasonable under the circumstances--

(1) it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;

(2) the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;

(3) the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and

(4) the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information or belief.

(n9)Footnote 9. *Fed. R. Bankr. P. 9011(f)*.

(n10)Footnote 10. 1987 Advisory Committee Note to *Fed. R. Bankr. P. 1002*, reprinted in Vol. A Collier on Bankruptcy, App. Pt. 2(c) (Matthew Bender 15th Ed. Revised).

(n11)Footnote 11. *See, e.g., Price v. Gurney*, 324 U.S. 100, 65 S. Ct. 513, 89 L. Ed. 776 (1945) ; *In re Joseph Feld & Co.*, 38 F. Supp. 506, 507 (D.N.J. 1941) (Bankruptcy Act cases). *See also, In re American Globus Corp.*, 195 B.R. 263, 265 (Bankr. S.D.N.Y. 1996) ; *In re Giggles Restaurant, Inc.*, 103 B.R. 549, 553 (Bankr. D.N.J. 1989) ; *In re Stavola/Manson Elec. Co., Inc.*, 94 B.R. 21, 24 (Bankr. D. Conn. 1988) ; *Keenihan v. Heritage Press, Inc.*, 19 F. 3d 1255, 1258 (8th Cir. 1994) (Bankruptcy Code Cases).

(n12)Footnote 12. *See, e.g., Del. Code Ann. tit. 8, § 141; N.Y. Bus. Corp. L. § 701; see also Boyce v. Chemical Plastics, Inc.*, 175 F.2d 839, 843 (8th Cir. 1949) , *cert. denied*, 338 U.S. 828, 70 S. Ct. 77, 94 L. Ed. 503 (1949) ; *In re Joseph Feld & Co.*, 38 F. Supp. 506, 507 (D.N.J. 1941) ; *In re Crescent Beach Inn, Inc.*, 22 B.R. 155, 158 (Bankr. D. Me. 1982) ; *cf. In re Phillips*, 966 F.2d 926, 934, 27 C.B.C.2d 464, 473 (5th Cir. 1992) , *reh'g denied*, 1992 U.S. App. LEXIS 20771 (5th Cir. Aug. 10, 1992) . *See generally* 1 *Collier Bankruptcy Practice Guide*, P 5.03 (Matthew Bender) for a discussion of the procedures to be applied in obtaining proper authorization for a corporation's chapter 11 filing.

(n13)Footnote 13. *See generally* 1 *Collier Bankruptcy Practice Guide*, P 5.03 (Matthew Bender). Counsel should examine the corporate by-law provisions relating to special meetings of the board of directors to determine how far in advance the notice should be sent to the directors and what information the notice must contain. Counsel should also review any rules regarding the location of the meeting, the recording of the minutes, the tabulation and taking of votes and the signatures of the directors. Many corporate by-laws and state statutes permit the adoption of resolutions by unanimous written consent or director participation in a board meeting by means of conference calls. In the interests of speed, the debtor may need to resort to such methods if the board of directors is very large or if members reside far from corporate headquarters.

(n14)Footnote 14. *See generally* 1 *Collier Bankruptcy Practice Guide*, P 5.03 (Matthew Bender).

(n15)Footnote 15. *Id.*

(n16)Footnote 16. *See generally id.*

(n17)Footnote 17. Additionally, the "Declaration Under Penalty of Perjury on Behalf of a Corporation or Partnership," as prescribed by Official Form 2, is incorporated into the petition filed on behalf of a corporation or partnership. The declaration requires an officer or authorized agent of the corporation or a member or authorized agent of the partnership to declare, under penalty of perjury, that the filing of the petition has been authorized. For Official Form 2, *see* www.uscourts.gov/bkforms/bankruptcy-forms.html official and Vol. A *Collier on Bankruptcy*, App. Pt. 2(d) and 11 *Collier on Bankruptcy*, Form No. 9.02-2 (Matthew Bender 15th Ed. Revised).

(n18)Footnote 18. *See, e.g.*, Rule 1074-1, "Corporate Resolution; Partnership Statement" of the Local Rules for the United States Bankruptcy Court Southern District of New York. The local bankruptcy rules for jurisdictions throughout the country are reprinted in *Collier Bankruptcy Practice Guide Local Rules Pamphlets* (Matthew Bender). *See generally* *Local Rules of the Bankruptcy Courts; Second Circuit* (Matthew Bender).

(n19)Footnote 19. 11 U.S.C. § 303(b)(3)(A). A general partner who does not consent to the filing may file an answer contesting the petition. 11 U.S.C. § 303(d). If the petition is timely controverted, the court may order relief only if it determines that: (1) the debtor is generally not paying its debts as they become due (unless the debts are the subject of a *bona fide* dispute as to liability or amount) or (2) within 120 days before the filing of the petition, a custodian was appointed or took possession of the debtor's property. 11 U.S.C. § 303(h).

(n20)Footnote 20. *See generally* 1 *Collier Bankruptcy Practice Guide*, P 5.03 (Matthew Bender).

(n21)Footnote 21. 11 U.S.C. 303(b)(3); *See also In re BC&K Cattle Co.*, 84 B.R. 69 (Bankr. D. Tex. 1998) .

(n22)Footnote 22. *See* 1 *Collier Bankruptcy Practice Guide*, P 5.03 (Matthew Bender).

(n23)Footnote 23. *See, e.g.*, Rule 1007-3 of the Local Rules for the United States Bankruptcy Court Southern District of New York available at www.nysb.uscourts.gov; Rule 1007-4 of the Local Rules for the United States Bankruptcy Court Eastern District of New York available at www.nyeb.uscourts.gov/rules/local_rules_0806a.pdf, *reprinted in* *Collier Bankruptcy Practice Guide Local Rules Pamphlets* (Matthew Bender), *Local Rules of the Bankruptcy Courts; Second Circuit* (Matthew Bender).

(n24)Footnote 24. *See, e.g.*, Rule 1074-1 of the Local Rules for the United States Bankruptcy Court Southern District of New York available at www.nyeb.uscourts.gov/rules/local_0806a.pdf, *reprinted in* *Collier Bankruptcy Practice Guide Local Rules Pamphlet*, *Local Rules of the Bankruptcy Courts; Second Circuit* (Matthew Bender).

(n25)Footnote 25. 28 U.S.C. § 1930(a)(3). The Judicial Conference, having the power to prescribe additional fees in cases under title 11, has amended the Bankruptcy Court Miscellaneous Fee Schedule several times. *See* Bankruptcy Court Miscellaneous Fee Schedule, *reprinted in* 1 *Collier on Bankruptcy*, Ch. App. 9 (Matthew Bender 15th Ed. Revised). The most recent revisions to the Fee Schedule became effective (available at www.nysb.uscourts.gov) December 22, 2008.

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), increased the filing fees for chapter 7 cases to \$220. In addition, the 2005 Act allows the district court or the bankruptcy court to waive, in accordance with Judicial Conference policy, fees prescribed under 28 U.S.C. § 1930. *See* 28 U.S.C. § 1930(f).

28 U.S.C. § 1930(a) was amended on November 11, 2000 to increase filing fees in chapter 9 cases to equal chapter 11 filing fees. 28 U.S.C. § 1930(a)(3). It also increases the filing fees for converting a case under chapter 7 or 13. 28 U.S.C.

§ 1930(a)(1).

(n26)Footnote 26. *Fed. R. Bankr. P. 2016(b)*. *Fed. R. Bankr. P. 2016(b)* also provides that a supplemental statement must be filed and transmitted to the United States trustee within 15 days after any payment or agreement that was not previously disclosed. *Id.*

(n27)Footnote 27. *11 U.S.C. § 329(a)*.

(n28)Footnote 28. *Fed. R. Bankr. P. 2016(b)*.

(n29)Footnote 29. *See 11 U.S.C. § 521; Fed. R. Bankr. P. 1007; Interim Rule 1007*. A checklist of the required lists, schedules, statements and fees, with cross-references to relevant Bankruptcy Code sections, Federal Rules of Bankruptcy Procedure and Official Forms, is contained in Bankruptcy Procedural Form B200, *reprinted in* Vol. 11 *Collier on Bankruptcy*, § 8.01[3] (Matthew Bender 15th Ed. Revised).

(n30)Footnote 30. *Section 1112(e) of the Code* specifies the penalties for failure to comply with the deadlines. Pursuant to section 1112(e), the court, on request of the United States trustee, may convert a case under chapter 11 to a case under chapter 7, or may dismiss a chapter 11 case:

if the debtor in a voluntary case fails to file, within fifteen days after the filing of the petition commencing such case or such additional time as the court may allow, the information required by paragraph (1) of section 521, including a list containing the names and addresses of the holders of the twenty largest unsecured claims ... and the approximate dollar amounts of each of such claims.

11 U.S.C. § 1112(e). In allowing the debtor 15 days to file the schedules before authorizing conversion or dismissal, section 1112(e) is somewhat inconsistent with certain deadlines set forth in *Fed. R. Bankr. P. 1007*.

(n31)Footnote 31. *See* 1987 Advisory Committee Note to *Fed. R. Bankr. P. 1007(f)*.

(n32)Footnote 32. Or, in the case of a partnership, a general partner or agent.

(n33)Footnote 33. Use of the software can greatly simplify the compilation and presentation of data. Additionally, the software can be useful throughout the case for docket control and general organizational purposes. *See* for example, the Collier TopForm Bankruptcy Filing Program (Matthew Bender).

(n34)Footnote 34. The production of the creditor list and schedule of liabilities may be accomplished by a claims processing agent appointed in large chapter 11 cases by the bankruptcy court pursuant to *28 U.S.C. § 156(c)*. *See* n. 44 and accompanying text *infra* for a discussion of the appointment of claims agents.

(n35)Footnote 35. *Fed. R. Bankr. P. 1007(d)*. The debtor should not include secured creditors on the list unless the value of the collateral is such that the unsecured deficiency places the creditor among the holders of the 20 largest unsecured claims. *See* Official Form 4, *reprinted in* Vol. A *Collier on Bankruptcy*, App. Pt. 2(d) and Vol. 11, *Collier on Bankruptcy*, Form Nos 8.02-4, 17.02-3 (Matthew Bender 15th Ed. Revised).

(n36)Footnote 36. *11 U.S.C. § 1102*.

(n37)Footnote 37. *See* n.58 *infra* for a discussion of the meaning of "contingent," "unliquidated" and "disputed." For Official Form 4, available at www.uscourts.gov/bkforms/bankruptcy-forms.html official Vol. A *Collier on Bankruptcy*, App. Pt. 2(d) and 11 *Collier on Bankruptcy*, Form Nos. 8.02-4 & 17.02-3 (Matthew Bender 15th Ed. Revised).

(n38)Footnote 38. *See Fed. R. Bankr. P. 1008; 28 U.S.C. § 1746(1)*. For Official Form 2 available at

www.uscourts.gov/bkforms/bankruptcy-forms.html official Vol. A, reprinted in Collier on Bankruptcy, App. Pt. 2(d) and Vol. 11 Collier on Bankruptcy, Form No. 8.02-2 (Matthew Bender 15th Ed. Revised).

(n39)Footnote 39. *See Fed. R. Bankr. P. 1007(d)*; *see also Bankruptcy Rule 9006(b)(2)*, which states that the court may not enlarge the time periods set forth in Bankruptcy Rule 1007(d).

(n40)Footnote 40. *Fed. R. Bankr. P. 1007(a)(1)*.

(n41)Footnote 41. *Fed. R. Bankr. P. 1007(a)(5)*.

(n42)Footnote 42. Specifications should be obtained directly from the clerk's office.

(n43)Footnote 43. *Fed. R. Bankr. P. 1007(a)(1)* requires the filing of a creditor list only if the petition is not accompanied by the debtor's schedule of liabilities. Local bankruptcy rules may require the filing of a creditor list even when a schedule of liabilities accompanies the petition. *See S.D.N.Y. Bankr. P. 1007-1, Del. R. Bankr. P. 1007-1*.

(n44)Footnote 44. The clerk of the bankruptcy court may require a debtor to employ an outside claims agent. The appointment of an outside claims agent is authorized pursuant to 28 U.S.C. § 156(c), as implemented by guidelines adopted by the Judicial Conference of the United States in March, 1989. Section 156(c) authorizes the courts to utilize outside facilities to provide notices, dockets and other administrative information to parties in bankruptcy cases. The outside claims agent acts in place of the clerk's office in performing those functions, but is paid out of assets of the estate. The retention of an outside claims agent must be authorized by the court. Because the claims agent may be considered a "professional," authorization for its retention should be sought pursuant to 28 U.S.C. § 156(c) and 11 U.S.C. § 327(a).

(n45)Footnote 45. *Fed. R. Bankr. P. 1007(a)(3)*.

(n46)Footnote 46. *Fed. R. Bankr. P. 1007(a)(3)-(4)*.

(n47)Footnote 47. I. Sulmeyer, D. Lynn & M. Rochelle, *Collier Handbook for Trustees and Debtors in Possession*, P 23.04 (Matthew Bender).

(n48)Footnote 48. *Fed. R. Bankr. P. 1007(i)*.

(n49)Footnote 49. *Fed. R. Bankr. P. 1007(j)*.

(n50)Footnote 50. *Fed. R. Bankr. P. 1007(b)(1)*; *see 11 U.S.C. § 521*; *see also* Official Forms 6 and 7, as amended to reflect changes made to the Bankruptcy Code by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, (2005) available at www.uscourts.gov/bkforms/bankruptcy-forms.html official Vol. A Collier on Bankruptcy, App. Pt. 2(d) (Matthew Bender 15th Ed. Revised).

Pursuant to section 521(a)(1)(B) and *Fed R. Bankr. P. 1007(b)(1)*, the court may relieve the debtor of its obligation to file any of the schedules and statements.

In the case of a partnership debtor, the general partners of the debtor are required to prepare and file the schedules and statements. *See Fed. R. Bankr. P. 1007(g)*.

(n51)Footnote 51. *Fed. R. Bankr. P. 1007(c)*.

(n52)Footnote 52. *Fed. R. Bankr. P. 1007(c)*. Additionally, *Fed. R. Bankr. P. 1007(c)* provides that "[n]otice of an extension shall be given to the United States trustee and to any committee, trustee, or other party as the court may direct."

(n53)Footnote 53. See P 9.08[3] *infra* for a discussion of the motion for the modification of time requirements.

(n54)Footnote 54. *Fed. R. Bankr. P. 1007(b)(1)*; Official Form 6 and the schedules thereto, as revised to reflect the 2005 amendments to the Bankruptcy Code.

(n55)Footnote 55. Schedule A should include all real property in which the debtor has any legal, equitable or future interest, including all property owned as a co-tenant, community property, or property in which the debtor has a life estate, and any property in which the debtor holds rights and powers exercisable for the debtor's own benefit. The debtor should not list leasehold interests in Schedule A. Such interests should be reported in Schedule G, the schedule of executory contracts and unexpired leases. See P 9.07[6][c][i][B] *infra* for a discussion of Schedule G.

(n56)Footnote 56. Only individual debtors may claim exempt property. See 11 U.S.C. § 522(b). See generally Collier Bankruptcy Exemption Guide (Matthew Bender).

(n57)Footnote 57. Schedule F of Official Form 6 was amended, effective September 25, 1997, to include a schedule identifying community liability for claims. Schedule E of Official Form 6 (or Form 6E) has been amended to implement the changes to claims priority in 11 U.S.C. § 507 made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005).

(n58)Footnote 58. The Code does not define the terms "disputed," "contingent" or "unliquidated." One commonly accepted definition is:

"Disputed" means that *liability* on the claim is not agreed upon by the debtor and the creditor.

"Unliquidated" means that the *dollar amount* of the claim is either not agreed upon or is unknown.

"Contingent" means that not all of the facts that are essential to the creation of liability have yet occurred.

6 *Collier on Bankruptcy*, P 925.03 (Matthew Bender 15th Ed. Revised) (*emphasis in original*). A debtor may be tempted to characterize liabilities as disputed, contingent and/or unliquidated, but should use those designations only when good faith grounds exist for doing so. A trustee or debtor should not list all claims as disputed, contingent, and unliquidated as a device to avoid the responsibility of carefully preparing schedules. 7 *Collier on Bankruptcy*, P 1111.02[3] (Matthew Bender 15th Ed. Revised).

Creditors whose claims are listed as contingent, unliquidated or disputed should be given specific notice of that fact to avoid questions as to whether the creditor received sufficient notice concerning the facts and basis of the dispute. See *id.* (citing *In re Rite Autotronics Corp.*, 27 B.R. 599, 602 (B.A.P. 9th Cir. 1982) , limited to Ch. 11 cases by *Kenitra, Inc. v. Lees-Carney & Co. (In re Kenitra, Inc.)*, 64 B.R. 841 (B.A.P. 9th Cir. 1986) .

(n59)Footnote 59. The debtor must also identify the unsecured portion of the claim, if any.

(n60)Footnote 60. Section 507(a)(1), (4)-(9) establishes priority for the following claims:

(1) domestic support obligations;

(2) claims for wages, salaries or commissions (including vacation, severance and sick leave pay) and commissions owed to certain independent sales representatives, earned within 180 days before the filing, up to \$10,950 for each claimant;

(3) claims for contributions to employee benefit plans arising from services rendered within 180 days before the filing, within certain dollar limits;

(4) certain claims against debtors who operate grain storage facilities or fish produce storage or

processing facilities;

(5) certain consumer claims for money deposited for goods or services that were not delivered or provided;

(6) claims for certain taxes and customs duties; and

(7) claims based upon a commitment by the debtor to a federal depository institution's regulatory agency or its predecessor to maintain the capital of an insured depository institution.

11 U.S.C. § 507(a).

Section 104 of the Bankruptcy Code, provides for an automatic adjustment of dollar amounts in certain sections of the Bankruptcy Code every three years beginning April 1, 1998, in order to reflect inflation. The effective date of the most recent increase in dollar amounts pursuant to this section was April 1, 2007. Official Forms 6E and 10 are also amended to reflect the adjusted dollar amounts. In cases filed before April 1, 2007, the old amounts still apply.

(n61)Footnote 61. The debtor must state the account number, if any, relating to each claim. Similarly, account numbers must be provided in Schedules D and E.

(n62)Footnote 62. Each claim should be listed only once in the schedule of liabilities. Even when a claim is secured only in part, it should be listed only in Schedule E. Similarly, even when a claim is entitled to priority only in part, it should be listed only in Schedule E. *See* General Instructions to Official Form 6, *reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 2(d) (Matthew Bender 15th Ed. Revised). If a creditor has more than one claim against the debtor, each claim should be listed separately. *Id.*

(n63)Footnote 63. *Fed. R. Bankr. P. 1007(b)(1)*. The Bankruptcy Code does not define the term "executory contract." However, a generally accepted definition of executory contract is "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other." Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 *Minn. L. Rev.* 439, 460 (1973).

(n64)Footnote 64. In the case of an unexpired lease, the debtor must state whether it is the lessor or lessee. The debtor also must state whether the lease is for non-residential real property and must provide the contract number of any government contract.

(n65)Footnote 65. To the extent that an out-of-court restructuring has been attempted, debtor's counsel already will have reviewed the major executory contracts and unexpired leases. *See* ch. 2 *supra*.

(n66)Footnote 66. 11 U.S.C. § 365(a).

(n67)Footnote 67. 11 U.S.C. § 365(d)(2). However, "on the request of any party to such contract or lease," the court "may order the trustee to determine within a specified period of time whether to assume or reject such contract or lease." *Id.*

(n68)Footnote 68. 11 U.S.C. § 365(d)(4), as amended by the Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n69)Footnote 69. *Id.*

(n70)Footnote 70. Until a lease of non-residential real property is assumed or rejected, the debtor in possession is

required to perform timely the obligations of the debtor arising under the lease from the date of the petition. *See 11 U.S.C. § 365(d)(3)*.

(n71)Footnote 71. Absent a showing of immediate and irreparable harm, a bankruptcy court cannot grant a motion to assume or reject an executory contract or unexpired lease within the 20 days after the petition date. *See Fed. R. Bankr. P. 6003(c)*.

(n72)Footnote 72. *11 U.S.C. § 365(d)(4)*.

(n73)Footnote 73. *11 U.S.C. § 521; Fed. R. Bankr. P. 1007(b)(1)*.

(n74)Footnote 74. *11 U.S.C. § 521; Fed. R. Bankr. P. 1007(b)(1)*. Official Form 7 has also been amended to reflect the 2005 amendments to the Bankruptcy Code. *See n.50 supra and accompanying text*.

(n75)Footnote 75. *See I. Sulmeyer, D. Lynn & M. Rochelle, Vol. 1 Collier Handbook for Trustees and Debtors in Possession, P 23.02[8]* (Matthew Bender) (containing a proposed disclaimer and suggesting that such disclaimer might prevent inaccuracies from being used against the debtor as admissions in litigation).

The Federal Rules of Bankruptcy Procedure themselves allow a debtor to amend a petition, schedule, statement or list at any time before the case is closed. *Fed. R. Bankr. P. 1009(a)*. The debtor must give notice of the amendment to the trustee and to any entity affected by the amendment. *Id.* Nonetheless, the express reservation of the debtor's right to correct inaccuracies in the required schedules is prudent.



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Collier Business Workout Guide

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CHAPTER 9 Preparing for Chapter 11

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P 9.08 First-Day Motions.

[1] Overview.

The filing of a voluntary petition under chapter 11 constitutes an order for relief.ⁿ¹ Pursuant to *sections 1107 and 1108 of the Bankruptcy Code*, the debtor, as debtor in possession, may continue to operate the debtor's business unless the court orders otherwise.ⁿ² The chapter 11 debtor will generally be free to take actions that are in the "ordinary course of business."ⁿ³ However, the debtor's ability to take certain actions, including actions outside the ordinary course of business, will be restricted upon the filing of the petition.

To facilitate the uninterrupted operation of the debtor's business, the debtor and its counsel must identify those actions that the debtor will need to take immediately after the filing that will be subject to the Bankruptcy Code's restrictions, and must arrange to give the requisite notices and obtain any necessary court authorizations for such activities. Additionally, the debtor's need for immediate court approval of orders relating to the administration of the bankruptcy case should be assessed. Based on these analyses, the debtor's counsel should, in the prefiling period, prepare appropriate motions and applicationsⁿ⁴ for filing with the court on the first day of the bankruptcy case.

[2] Retention of Counsel and Other Advisors.

Immediately upon the filing of a chapter 11 petition, the debtor will find it necessary to employ one or more professional persons, including counsel to represent it in the chapter 11 case. In addition, the debtor may need to retain special counsel to represent it in actions that will require the debtor's immediate attention. For example, such representation may be required in a lawsuit brought by the debtor prior to the filing. Also, for certain litigation commenced against the debtor prepetition that is not subject to the Bankruptcy Code's automatic stay provisions, the debtor may need to retain special counsel. Depending on the size of the case, the debtor also may have immediate need for the services of other professionals, including accountants, investment bankers, management consultants and outside claims agents.

[a] Qualification to Represent the Debtor.

Pursuant to *section 327(a) of the Bankruptcy Code*, the debtor in possession may, with the court's approval, employ attorneys, accountants, appraisers, auctioneers or other professional persons to represent or assist the debtor in possession in carrying out its duties.ⁿ⁵ A professional may be employed pursuant to section 327(a) only if the

professional does "not hold or represent an interest adverse to the estate" and is a "disinterested person."ⁿ⁶ The Code defines "disinterested person" in section 101 as a person who:

(A) is not a creditor, an equity security holder, or an insider;

(B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and

(C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason.ⁿ⁷

Any professional that cannot meet the disinterestedness standard will not be qualified for retention pursuant to section 327(a).ⁿ⁸ Several issues, outlined below, frequently arise with respect to qualification for employment.ⁿ⁹

[i] Prior Representation of the Debtor.

A difficulty in retaining professionals may arise when the attorney or other professional sought to be retained has represented the debtor prior to the filing. *Section 1107(b) of the Bankruptcy Code* provides that: "Notwithstanding section 327(a) of this title, a person is not disqualified for employment under section 327 of this title by a debtor in possession solely because of such person's employment by or representation of the debtor before the commencement of the case." While section 1107(b) provides that prior representation does not, by itself, disqualify a professional from employment under section 327, a professional who has represented the debtor before the chapter 11 filing may nonetheless be disqualified for other reasons. Most significantly, if a professional's prior representation of the debtor resulted in fees accrued but unpaid as of the filing date that are not covered by any retainer provided to the professional prepetition,ⁿ¹⁰ the professional will be a creditor. Consistent with the language of section 101, most courts take the position that a professional who is owed fees earned prepetition, especially if such fees are unrelated to the bankruptcy case, will not be deemed a "disinterested person."ⁿ¹¹ Additionally, as a creditor, the professional would likely be deemed to "hold or represent an interest adverse to the estate."ⁿ¹²

One way in which the disqualification problem might be avoided is for the attorney or other professional to waive the outstanding prepetition fees.ⁿ¹³ Practical limitations to this solution exist, however. First, a professional will normally be willing to waive prepetition fees only if they are insignificant compared with the fees expected to be generated in the bankruptcy case. Second, an unscrupulous professional may attempt to collect all or part of the waived fees by simply charging more for postpetition services.ⁿ¹⁴ But for many professionals, waiving prepetition fees may be a sensible solution.

While an attorney with a prepetition claim against the debtor generally will be disqualified under section 327(a), the attorney should not be precluded from acting as special counsel to the debtor pursuant to section 327(e). Under that section, the court may approve the employment, for a specified special purpose, of an attorney that has represented the debtor prepetition. Section 327(e) requires that special counsel not represent or hold any interest adverse to the debtor or the estate with respect to the matter on which such attorney is to be employed.ⁿ¹⁵ Section 327(e) does not include the "disinterestedness" requirement that is contained in section 327(a). Therefore, the fact that the attorney has a prepetition claim against the debtor should not bar the attorney's retention as special counsel.

[ii] Representing Affiliated Debtors.

Chapter 11 filings often involve several affiliated corporate entities. In such situations, the debtors will usually request that the cases be jointly administered and that a single law firm be appointed to represent all the affiliated debtors.ⁿ¹⁶ In

general, courts are willing to allow the representation of multiple affiliates by a single law firm, provided that no actual conflict of interest between the affiliates exists.ⁿ¹⁷ However, to the extent an actual conflict arises (*e.g.*, a dispute over an intercompany claim), both debtors should be prepared to retain separate counsel pursuant to section 327(a) to represent them with respect to that dispute.

[iii] Representing a Corporate Debtor and Its Principals or Insiders.

The debtor's retention of counsel who also represents the debtor's principals or insiders may be problematic. In general, courts will not allow the simultaneous representation of a debtor and the principals or insiders of the debtor.ⁿ¹⁸ A minority of courts, however, have allowed such representation, finding that merely a potential conflict, rather than an actual conflict, is not enough to disqualify an attorney.ⁿ¹⁹

[iv] Representing the Debtor and a Creditor.

An issue may arise with respect to a professional's representation of the debtor and a creditor of the debtor. *Section 327(c) of the Bankruptcy Code* provides:

a person is not disqualified for employment under this section solely because of such person's employment by or representation of a creditor, unless there is objection by another creditor or the United States trustee, in which case the court shall disapprove such employment if there is an actual conflict of interest.ⁿ²⁰

Courts generally agree that an actual conflict of interest will arise and prevent dual representation if the professional represents the creditor in connection with the bankruptcy case.ⁿ²¹ Less uniformity exists, however, in the treatment of professionals who represent the debtor and creditors in unrelated matters.ⁿ²²

Although section 327(c) seems to require an objection before a professional will be disqualified from representing a creditor and the debtor, courts may disallow a professional's compensation even when no objection to the representation is voiced.ⁿ²³

[b] Obtaining Court Approval.

A request for the employment of professionals pursuant to section 327 must be made by application to the bankruptcy court.ⁿ²⁴ The application must state the specific facts showing the necessity for the employment, the name of the person to be employed, the reasons for the selection, the professional services to be rendered, any proposed arrangement for compensation, and, to the best of the applicant's knowledge, all of the professional's connections with the debtor, creditors, or any other party in interest, their respective attorneys and accountants, the United States trustee or any person employed in the United States trustee's office.ⁿ²⁵

The application must be:

accompanied by a verified statement of the person to be employed setting forth the person's connections with the debtor, creditors, or any other party in interest, their respective attorneys and accountants, the United States trustee, or any person employed in the office of the United States trustee.ⁿ²⁶

In the case of an application for retention pursuant to section 327(a), the professional firm should establish in the affidavit that it is a "disinterested person."ⁿ²⁷

In the prefiling period, counsel for the prospective debtor should prepare, for filing on the first day, the debtor's application for an order approving the law firm's retention and the firm's own affidavit to accompany the application. To

the extent that the debtor will require the services of other professionals immediately after the bankruptcy filing, such professionals should be identified and the retention papers should be prepared. It is important to remember that every attorney for a debtor, whether or not the attorney applies for compensation, must, within 15 days after the commencement of the bankruptcy case, file with the court and transmit to the United States trustee a disclosure of compensation paid or agreed to be paid.ⁿ²⁸

Obtaining prompt court approval of the employment of professionals whose services will be required immediately is vital since the professionals cannot be paid for services rendered prior to their retention.ⁿ²⁹ The fees and expenses due a professional who has not received court approval may still be paid if the court is willing to approve the employment retroactively. However, this retroactive approval is not always availableⁿ³⁰ and, therefore, every effort should be made to procure court-ordered retention of professionals at the earliest possible time.ⁿ³¹

[3] Modification of Time Requirements.

As discussed above, the schedules, statements and lists required by *section 521(1) of the Bankruptcy Code* and *Federal Rule of Bankruptcy Procedure 1007* must be filed with the voluntary petition or soon thereafter, absent a modification of the relevant deadlines. Accordingly, if the debtor believes that it is impossible or impracticable to meet the time requirements, counsel should prepare a motion to modify such requirements for filing on the first day of the bankruptcy case. The Federal Rules of Bankruptcy Procedure provide for an extension of most of the deadlines on motion for cause shown and on notice to the United States trustee and to any committee, trustee or other party as the court may direct.ⁿ³² Generally, a debtor will provide advance notice of the first-day motions to the United States trustee and, if practicable, to the creditors listed on the debtor's list of twenty largest unsecured creditors, and the court will deem such notice to be sufficient. If an unofficial committee of creditors has been formed prior to the filing date, it is advisable to provide notice of the motion to such committee.

[4] Joint Administration.

For reasons of economy and efficiency, the joint administration of the bankruptcy cases of related debtors is generally desirable. Absent exceptional circumstances, counsel for the debtor(s) should prepare a first-day motion seeking the court's approval of a joint administration order covering the cases of all affiliated debtors.ⁿ³³

Pursuant to *Federal Rule of Bankruptcy Procedure 1015(b)*, the court may order that bankruptcy cases involving related debtors (including a debtor and an affiliate)ⁿ³⁴ be administered jointly.ⁿ³⁵ Joint administration of separate bankruptcy cases does not result in combining the assets and liabilities of the debtors, but rather preserves their status as separate entities.ⁿ³⁶ However, administrative matters that arise in the cases would be jointly handled, thereby increasing judicial efficiency and preserving the assets of the estates.ⁿ³⁷

Joint administration may include using a single docket for the matters occurring in the administration of the cases, including the combining of notices to creditors of the estates and the meetings of creditors, and the joint handling of other purely administrative matters.ⁿ³⁸ In jointly-administered cases, the debtors may file a single motion if they seek the same relief and the court may hold a single hearing and enter a single order granting or denying the relief.ⁿ³⁹

[5] Payment of Prepetition Obligations.

The automatic stay of *section 362 of the Bankruptcy Code* generally will defer until the end of the bankruptcy case a debtor's obligation to pay outstanding prepetition debts.ⁿ⁴⁰ This applies to the debtor's obligations to its employees and suppliers. However, the debtor may determine that any advantage of this cash flow benefit would be outweighed by the harm to its employees and suppliers who are essential to the continued operation of its business and, accordingly, may seek court authorization to pay prepetition employee or supplier claims. If the debtor seeks authorization to make such payments to employees and suppliers, the court must decide whether to, in effect, grant priority to these groups over

other creditor constituencies.ⁿ⁴¹

[a] Employees.

The debtor's interest in maintaining the cooperation of its employees is best served by ensuring that employee wages are current as of the filing date. Accordingly, the debtor might decide to file its bankruptcy petition immediately after its usual pay day. Alternatively, if the debtor does not have flexibility in the timing of the filing, the debtor may want to deviate from its normal payroll cycle to pay its employees immediately prior to the filing of the petition. However, in the case of a large corporate debtor, these options may not be available and, in any event, are not likely to be complete solutions. Even if all employees could be paid immediately before the filing, payment by means other than certified check will result in outstanding checks that will not clear because of the filing. Payment by certified check often will be impractical and excessively costly. Additionally, deviation from usual payment procedures may result in unwanted pre-filing disclosure of the company's circumstances. Therefore, it will be difficult for a large corporate debtor to avoid having accrued and unpaid wages on the filing date.

To the extent that accrued wages remain unpaid as of the filing date, a debtor with an ongoing business may want to seek the court's approval to pay the wages immediately after the filing or to allow checks issued prepetition to clear.

Pursuant to *section 507(a)(4) of the Bankruptcy Code*, certain claims by employees are accorded priority over the claims of general unsecured creditors. The claims entitled to priority are those for wages, salaries or commissions (including vacation, severance and sick leave pay), up to \$10,950 per employee, earned within 180 days before the earlier of the bankruptcy filing or the date of the cessation of the debtor's business.ⁿ⁴² A wage claim by an employee above the \$10,950 limit or outside of the 180-day period is a general unsecured claim.

While certain employee wage claims are given priority treatment, the claims ordinarily cannot be paid until distributions are made under a plan of reorganization. However, if employees are forced to wait for payment of their wage claims until the end of the bankruptcy case, the debtor may suffer from a significant loss in employee morale and cooperation. Because of the importance of continued employee services, bankruptcy courts have authorized debtors to make postpetition payments on prepetition employee wage claims.ⁿ⁴³ Many courts will, however, limit the payments to the priority amounts authorized under *section 507(a)(4)*.ⁿ⁴⁴

If the debtor will have accrued unpaid wages on its filing date and believes that payment of such wages is important to the continued operation of its business, counsel for the debtor should prepare, for filing on the first day, a motion pursuant to *section 105(a) of the Bankruptcy Code*,ⁿ⁴⁵ for authority to make the payments.

The debtor may also want to seek authority to pay certain prepetition employee benefit claims. Like wage claims, certain employee benefit claims are accorded priority treatment over general unsecured claims. Pursuant to *section 507(a)(5)*, priority treatment is accorded to claims for contributions to employee benefit plansⁿ⁴⁶ arising from services rendered by the employees within 180 days of the filing of the petition, for each such plan, up to the number of employees covered multiplied by \$10,950 and minus (i) wage claims paid as priority claims to such employees and (ii) the amounts paid by the estate on behalf of such employees to any other employee benefit plan.

The bankruptcy court is most likely to authorize postpetition payment of prepetition employee benefit claims that are covered by the *section 507(a)(5)* priority. Courts have authorized such payments, pursuant to *section 105(a)*, when the payments are shown to be necessary to preserve employee morale and the continued service of essential employees.ⁿ⁴⁷

[b] Suppliers.

To secure the continued supply of essential goods and services, the debtor may decide to seek authority to pay prepetition debts owed to significant suppliers. Bankruptcy courts may be willing to authorize their payment if the

debtor can demonstrate that such payments are essential to the debtor's continued business operations.ⁿ⁴⁸ Such motions are made frequently in Chapter 11 cases. In addition, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 enhances the rights of suppliers of goods and services in several ways.ⁿ⁴⁹ For instance, a seller, who provided goods in the ordinary course of business to an insolvent debtor, may reclaim such goods if the seller makes a written demand within 45 days of the debtor's receipt of the goods or within 20 days after filing the bankruptcy petition if the original 45-day period expires after the commencement of the bankruptcy case.ⁿ⁵⁰ In addition, even if the seller fails to give written notice, the seller receives an administrative expense priority claim for the value of any goods received by the debtor within 20 days before the date of commencement of a case.ⁿ⁵¹

[6] Debtor's Cash Needs.

Debtors frequently file voluntary petitions under the Bankruptcy Code when they have nearly exhausted their cash reserves for operating their businesses. Even though the company gets a one-time benefit when it files as a result of not paying prepetition creditors, after the chapter 11 filing the debtor can suffer a drastic reduction in trade financing because many of the suppliers which had formerly extended credit on normal or deferred terms may now insist on dealing with the debtor only on a cash-and-carry basis. Cash flow might also be reduced in the period immediately following the filing as customers worry about the continued viability of the company. Finally, the Bankruptcy Code places many restrictions on the debtor's ability to use the cash in its possession and to obtain new financing. The debtor and its counsel will need to determine the debtor's cash needs and resources prior to filing under chapter 11 and counsel for the debtor often will need to prepare cash collateral or postpetition financing motions for filing with the court on the first day of the chapter 11 case or soon thereafter.

[a] Cash Collateral.

The Bankruptcy Code places more restrictions on the use of "cash collateral" than on any other type of property.ⁿ⁵² While the debtor may use most forms of property in the ordinary course of its business without any prior court authorization,ⁿ⁵³ the debtor may not use cash collateral unless each entity with an interest in the property consents or "the court, after notice and a hearing, authorizes such use, sale, or lease."ⁿ⁵⁴ Without consent or court authorization, the debtor must "segregate and account for any cash collateral" in its "possession, custody, or control."ⁿ⁵⁵

[i] Cash Collateral Defined.

Section 363 of the Bankruptcy Code defines "cash collateral" as:

cash, negotiable instruments, documents of title, securities, deposit accounts, or other cash equivalents whenever acquired in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents, or profits of property and the fees, charges, accounts or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties subject to a security interest as provided in section 552(b) of this title, whether existing before or after the commencement of a case under this title.ⁿ⁵⁶

As the Code's definition illustrates, the term cash collateral encompasses more than cash or cash equivalents on which a creditor has a lien. Cash collateral includes proceeds from the sale or use of property subject to a security interest and cash which, under state law, would not necessarily be considered collateral.ⁿ⁵⁷ For example, if a creditor bank would have had a right of setoff against the debtor's bank account during the prepetition period, then, subsequent to the filing, that account will be considered cash collateral to the extent of the bank's claim and the debtor must obtain the bank's consent or court authorization to use funds in the account.ⁿ⁵⁸

[ii] Authorization of the Use of Cash Collateral.

The broad definition of cash collateral suggests that most debtors in possession will need access to cash collateral at

some point during a chapter 11 case, often at its inception. If access to cash collateral will be required in the very early stages of the case, arrangements to obtain creditor consent or court authorization should be made during the prefiling period. The analysis of when the debtor should be prepared to make any necessary motions (to approve an agreement for the use of cash collateral or for court authorization for such use in the absence of creditor consent) must take into account the notice requirements set forth in the Bankruptcy Code and Rules. Those requirements are discussed below.

Before the start of the case, the debtor may attempt to secure from all entities holding an interest in the cash collateral their express consentⁿ⁵⁹ to the debtor's use of such collateral. The debtor will have to weigh the risks of disclosing the news of its impending filing to its creditors against the desirability of obtaining immediate access to the cash collateral.

If the creditors do consent, the debtor must submit to the court a motion to approve the agreement together with the agreement itself.ⁿ⁶⁰ The debtor must serve this motion on any committee or its authorized agent (or, if no committee of unsecured creditors has been appointed, the motion must be served on the creditors included on the debtor's list of 20 largest unsecured creditors), the United States trustee and such other entities as the court may direct.ⁿ⁶¹ Objections to the motion may be filed within 15 days of the mailing of the notice.ⁿ⁶² If no party objects, the court may enter an order approving or disapproving the agreement without conducting a hearing.ⁿ⁶³ If a party objects or the court determines that a hearing is appropriate, the court will hold a hearing on no less than five days' notice to the objecting party, the movant, all parties on whom service of the motion was required, and such other entities as the court directs.ⁿ⁶⁴

If the debtor cannot obtain the interested creditors' consent, the debtor should be prepared to move for authorization to use the cash collateral.ⁿ⁶⁵ The motion is required to, among other things, consist of or include a concise statement of the relief requested (not to exceed five pages), that lists or summarizes, and sets out the location within the relevant documents of, all material provisions of the proposed form of order or agreement. ⁿ⁶⁶ The motion should be made in accordance with *Federal Rules of Bankruptcy Procedure 4001(b)* and 9014ⁿ⁶⁷ and the debtor must serve the motion on any entity which has an interest in the cash collateral, any committee or its authorized agent (or, if no committee of unsecured creditors has been appointed, on the creditors included on the list of the debtor's 20 largest unsecured creditors), the United States trustee, and such other entities as the court may direct.ⁿ⁶⁸ As a technical matter, if, after appropriate notice, no party requests a hearing, no hearing is required.ⁿ⁶⁹ As a practical matter, however, a hearing generally will be held.

Pursuant to the Federal Rules of Bankruptcy Procedure, the "court may commence a final hearing on a motion for authorization to use cash collateral no earlier than 15 days after service of the motion."ⁿ⁷⁰ The court may, however, conduct a preliminary hearing before the 15-day period expires.ⁿ⁷¹ The notice required for the preliminary hearing will vary depending upon the circumstances of the case.ⁿ⁷² As a general rule, courts are unwilling to dispense completely with notice.

The court may authorize the use, sale or lease of cash collateral at the preliminary hearing "only if there is a reasonable likelihood that the trustee [or debtor in possession] will prevail at the final hearing under subsection (e) of [section 363]."ⁿ⁷³ Moreover, the Federal Rules of Bankruptcy Procedure provide that "the court may authorize the use of only that amount of cash collateral as is necessary to avoid immediate and irreparable harm to the estate pending a final hearing" under subsection (e) of section 363.ⁿ⁷⁴

Upon the motion of an entity that has an interest in cash collateral used, sold or leased, or proposed to be used, sold or leased, the court must prohibit or condition the debtor's use, sale or lease so as to ensure that the creditor's interest in the property is adequately protected.ⁿ⁷⁵ Accordingly, the debtor should be prepared to demonstrate, during the preliminary and final hearings, that all creditors with an interest in the cash collateral are adequately protected.ⁿ⁷⁶

[b] Debtor-in-Possession Financing.

The debtor may also need a motion for an order authorizing postpetition financing. Since a chapter 11 debtor cannot

assume any prepetition financing agreements,ⁿ⁷⁷ it usually will be necessary for the debtor to make new financing arrangements. To the extent that financing will be needed, the debtor should, as early as possible in the preparation period, make all efforts to negotiate an appropriate financing agreement. Additionally, debtor's counsel should prepare any necessary motion papers for filing with the bankruptcy court on the first day of the case, or as soon thereafter as is necessary to meet the debtor's financing needs.

[i] Financing Under the Bankruptcy Code.

Section 364 of the Bankruptcy Code identifies four types of financing arrangements available to a debtor: (1) unsecured financing in the ordinary course of business; (2) unsecured financing outside the ordinary course of business; (3) superpriority and secured financing; and (4) financing which "primes" existing liens.

Section 364(a) permits the debtor in possession to obtain unsecured credit and incur unsecured debt in the ordinary course of business without court authorization as an administrative expense.ⁿ⁷⁸ An entity extending credit on this basis receives priority in its claim over prepetition unsecured debts.ⁿ⁷⁹ Most entities will refuse to advance substantial credit on this basis, however, because they desire some securityⁿ⁸⁰ or feel uncomfortable with the undefined "ordinary course of business" standard set forth in the Code. If, after the financing is obtained, the court determines that the debt was incurred outside the ordinary course of business without court authorization, the creditor may lose its claim against the estate under the credit agreement.ⁿ⁸¹

If the debtor arranges to obtain unsecured credit or incur unsecured debt outside the ordinary course of business allowable as an administrative expense, *section 364(b) of the Bankruptcy Code* requires that the court authorize such arrangement.ⁿ⁸² However, section 364(b) financing is not likely to satisfy a debtor's needs for substantial credit because, as noted above, most creditors will seek more protection than the administrative expense priority.ⁿ⁸³

In the likely event that the debtor is unable to obtain unsecured credit pursuant to section 364(a) or (b), the court may authorize the debtor to obtain credit or incur debt:

- (i) with priority over any or all administrative expenses of the kind specified in sections 503(b) and 507(b); (ii) secured by a lien on property of the estate that is not otherwise subject to a lien; or (iii) secured by a junior lien on property of the estate that already is subject to a lien.ⁿ⁸⁴

When all of the debtor's property is subject to liens or when the property that is not subject to liens has value insufficient to secure the debtor in possession's loan, the debtor may need to offer the postpetition lender a senior or equal lien on property of the estate that already is encumbered. Under section 364(d), the court may approve such an arrangementⁿ⁸⁵ only if the debtor cannot obtain financing otherwiseⁿ⁸⁶ and the interest of the holder of the lien being primed is adequately protected.ⁿ⁸⁷

Authorization of postpetition financing arrangements can be obtained only upon the submission to the bankruptcy court of a motion accompanied by the proposed financing agreement.ⁿ⁸⁸ Generally, the motion is required to, among other things, consist of or include a concise statement of the relief requested (not to exceed five pages), that lists or summarizes, and sets out the location within the relevant documents of, all material provisions (including, e.g., economic terms, maturity, events of default and borrowing conditions).^{n88a} The motion must also include descriptions of, and references to, certain forms of extraordinary relief (e.g., granting of superpriority status, priming liens and releases), and identify any provision that is proposed to remain in effect if interim approval is granted, but final relief is denied.^{n88b} The motion should include a description of efforts, if any, made to obtain credit from other sources and the inability to obtain it.ⁿ⁸⁹ If the motion is made pursuant to section 364(c) or (d), the debtor should also describe the collateral, if any, to be used to secure the financing and identify the protection to be provided for any existing interest in the collateral which will be affected by the agreement.ⁿ⁹⁰

The motion should be made in accordance with *Federal Rules of Bankruptcy Procedure 4001(c)* and *9014* and the debtor must serve the motion on any committee or its authorized agent (or, if no committee of unsecured creditors has been appointed, on the creditors included on the list of the debtor's 20 largest unsecured creditors), the United States trustee and such other entities as the court may direct.ⁿ⁹¹ The debtor is also advised to notify any entity whose lien would be primed under the proposed financing agreement.

The court may commence a final hearing on the motion for authorization of financing no earlier than 15 days after service of the motion.ⁿ⁹² The Bankruptcy Rules do, however, permit a preliminary hearing before the expiration of the 15-day period.ⁿ⁹³ At the preliminary hearing, the court may authorize the obtaining of credit "only to the extent necessary to avoid immediate and irreparable harm to the estate pending a final hearing."ⁿ⁹⁴

The notice required for a preliminary hearing may vary depending upon the type of financing being proposed. When the financing motion is made pursuant to section 364(c) or (d), courts are reluctant to find that emergency conditions justify the debtor's dispensing with notice to the affected creditors.ⁿ⁹⁵

[ii] Cross-Collateralization and Roll-ups.

It is sometimes easiest for the debtor to obtain postpetition credit from its prepetition lenders. These lenders often will attempt to obtain additional security and priority for their prepetition claims as a condition to postpetition financing. Most often, the lender will ask the debtor to "cross-collateralize" the estate's assets to secure or further secure the prepetition loans.ⁿ⁹⁶ Recently, prepetition lenders have also required that prepetition financing be "rolled up" into postpetition financing, resulting in the entire loan being secured and postpetition.

Bankruptcy courts have disagreed about whether cross-collateralization is permissible under the Bankruptcy Code.ⁿ⁹⁷ In 1992, the Eleventh Circuit became the first of the Courts of Appeals to rule on this issue.ⁿ⁹⁸ In *In re Saybrook Manufacturing Co., Inc.*,ⁿ⁹⁹ the court held that cross-collateralization is an impermissible means of obtaining postpetition financing under the Bankruptcy Code.ⁿ¹⁰⁰

The *Saybrook* court found that *section 364 of the Code*, which enumerates the methods of postpetition financing, does not authorize cross-collateralization.ⁿ¹⁰¹ The court further concluded that authorizing cross-collateralization is beyond a bankruptcy court's equitable powers because it is "directly contrary" to the priority scheme set forth in *section 507 of the Code*.ⁿ¹⁰² Permitting an unsecured or undersecured creditor to cross-collateralize and obtain priority for its prepetition claims would, according to the Court of Appeals for the Eleventh Circuit, unjustly alter the priorities and create an impermissible superpriority within a class of creditors.ⁿ¹⁰³

Prepetition lenders also providing postpetition financing may require that some or all of the prepetition financing be "rolled-up" into the postpetition financing. This results in the entire prepetition facility becoming a postpetition secured facility with super-priority administrative expenses status. While not preferred by debtors or courts, debtors whose prepetition lenders are the only parties willing to provide postpetition financing may have little choice but to acquiesce.^{n103a}

[7] Cash Management.

If the debtor is part of a corporate group whose members share a consolidated cash management system, the debtor may consider seeking court authority to continue to use such a system during the chapter 11 case.ⁿ¹⁰⁴ To the extent that the court does enter a cash management order, it may refuse to authorize the inclusion of non-debtor affiliates in the cash management system.ⁿ¹⁰⁵ The court also may restrict the transfer of large amounts of cash between entities without prior notice and hearing.ⁿ¹⁰⁶ Finally, the court almost certainly will require the debtors involved in a cash management system to maintain strict records of all transfers.ⁿ¹⁰⁷

[8] Use, Sale, or Lease of Property.

To the extent that the debtor anticipates selling, leasing or using property of the estate outside the ordinary course of business immediately after filing its petition, advance planning is necessary to facilitate the action. While most debtors will not have an immediate need to use, sell or lease property out of the ordinary course at the inception of the case, circumstances may arise in which a debtor will need to take such actions. For example, a sale of major assets may provide a necessary cash infusion (perhaps obviating the need for debtor-in-possession financing) or may persuade the purchaser or other entity to provide postpetition financing.ⁿ¹⁰⁸

Pursuant to *section 363(b)(1) of the Bankruptcy Code*, the debtor may use, sell or lease property out of the ordinary course of business "after notice and hearing."ⁿ¹⁰⁹ The notice of the proposed transaction should describe the property, state the time and place of any public sale, describe the terms and conditions of any private sale and state the time fixed for filing objections.ⁿ¹¹⁰ The Bankruptcy Rules require the debtor to provide 20 days' notice by mail of the proposed use, sale or lease to any committee appointed pursuant to *section 1102 of the Bankruptcy Code* (or elected pursuant to section 705), to all creditors and indenture trustees and to the United States trustee.ⁿ¹¹¹ The bankruptcy court may shorten the notice period, limit the entities to whom notice must be given, or direct that another method be used for giving notice.ⁿ¹¹² However, absent a showing of immediate and irreparable harm, the court may not enter an order approving the sale within the 20 days after the petition date.ⁿ¹¹³

Pursuant to section 363(b)(1), the debtor need not obtain a court order authorizing the proposed use, sale or lease. If no objections to the debtor's proposed use, sale or lease are received at least five days before the date set for the proposed action, or within the time otherwise set by the court, no hearing need be held, and the debtor may simply enter into the transaction.ⁿ¹¹⁴ However, in the case of a sale of substantial assets, an order authorizing the transaction likely will be sought and a hearing will be held. The entity purchasing or leasing assets from a chapter 11 debtor will want a court order as evidence that it has good title to the assets. Additionally, the buyer or lessee will want an express finding by the court that it purchased or leased the property in "good faith."ⁿ¹¹⁵

On the motion of an entity with an interest in property that the debtor proposes to use, sell or lease, the court is required to prohibit or condition the use, sale or lease as is necessary to provide adequate protection of the entity's interest.ⁿ¹¹⁶ Accordingly, the debtor should be prepared to demonstrate that interested entities are adequately protected.

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 301(b)*.

(n2)Footnote 2. Section 1108 provides that, unless the court orders otherwise, the trustee may operate the debtor's business. *See 11 U.S.C. § 1108*. Section 1107 provides that a debtor in possession has the rights and powers of a chapter 11 trustee and is required to perform the functions and duties of a chapter 11 trustee. *See 11 U.S.C. § 1107*. Accordingly, statutory references in the Bankruptcy Code to the "trustee" are read to include the "debtor in possession." *See also Fed. R. Bankr. P. 9001(11)* (" 'Trustee' includes a debtor in possession in a chapter 11 case. ").

(n3)Footnote 3. *11 U.S.C. §§ 363(c)(1) and 364(a)*; *see 11 U.S.C. § 1108*.

(n4)Footnote 4. Pursuant to *Fed. R. Bankr. P. 9013*, "[a] request for an order, except when an application is authorized by [the Bankruptcy Rules], shall be by written motion, unless made during a hearing." Among the instances in which an application is authorized are a request, pursuant to *Fed. R. Bankr. P. 2014*, for approval of the employment of a professional. *Rule 5003(e)* requires the court's clerk to keep addresses of federal and state governmental agencies so that the debtors, their attorneys, and other parties may determine whether the governmental agency has filed a statement designating a mailing address for notice purposes. *See 2000 Advisory Committee Note to Fed. R. Bankr. P. 5003(e)*. In 2005, section 505(b)(1) was added to the Bankruptcy Code to require the clerk to maintain a list under which a federal, state, or local taxing authority responsible for collecting taxes within the district may designate an address for service

and other information. *See also Rule 5003(e).*

(n5)Footnote 5. 11 U.S.C. § 327(a). Situations may arise in which doubt exists as to the definition of "professional" and, thus, as to whether an individual must be retained pursuant to a court order. In such situations, consultation with the United States trustee might be advisable. *See 3 Collier on Bankruptcy, P 327.02* (Matthew Bender 15th Ed. Revised).

(n6)Footnote 6. 11 U.S.C. § 327(a).

(n7)Footnote 7. 11 U.S.C. § 101(14), as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005. Prior to the amendment, the term "disinterested person" included a person who was an investment banker for any outstanding security of the debtor or who was an investment banker for any security of the debtor within three years before the filing of the bankruptcy petition. The amendment changes this standard and allows an investment banker, its employees, and attorneys to continue to represent the debtor in bankruptcy, subject only to the requirement that such persons are not creditors, equity security holders, or insiders, and do not hold an interest materially adverse to the estate, the debtor, its creditors, or equity security holders.

(n8)Footnote 8. 11 U.S.C. § 327(a). Section 327(e), on the other hand, does not require that an attorney retained as special counsel pursuant to that section be disinterested. Additionally, while a professional who holds or represents any interest adverse to the estate is disqualified from employment under section 327(a), under section 327(e), an attorney who has previously represented the debtor may be employed if the attorney "does not represent or hold any interest adverse to the debtor or to the estate *with respect to the matter on which such attorney is to be employed.*" *See 11 U.S.C. § 327(e) (emphasis added).*

(n9)Footnote 9. For a more detailed discussion of such issues, *see generally*, S. Bernstein, Collier Compensation, Employment and Appointment of Trustees and Professionals in Bankruptcy Cases, ch. 1 (Matthew Bender).

(n10)Footnote 10. Professionals, particularly lawyers, often insist on receiving retainers from the debtor at some time prior to the chapter 11 filing. Such retainers are desired because professionals want assurance that they will not be unsecured creditors of the debtor by virtue of fees and disbursements that were not billed because of accounting errors and delays. Further, professionals generally want some security in respect of future fees, particularly if the debtor's ability to satisfy administrative expense claims is questionable. The fact that a professional has received a retainer prior to the filing should not be a basis for disqualification. *See, e.g., In re K & R Mining, Inc.*, 105 B.R. 394, 397 (Bankr. N.D. Ohio 1989) ; *Weinman, Cohen & Niebrugge, P.C. v. Peters (in re Printcrafters, Inc.)*, 233 B.R. 113, 115 (D. Colo. 1999) (attorney who holds retainer securing payment for services to be rendered in bankruptcy case not disqualified to serve as counsel to debtor); *see also In re Burnside Steel Foundry Co.*, 19 C.B.C.2d 761, 762-63, 90 B.R. 942, 943 (Bankr. N.D. Ill. 1988) (counsel for debtor held prepetition retainer to secure payment of fees to be earned in bankruptcy case).

(n11)Footnote 11. *See In re Siliconix, Inc.*, 135 B.R. 378, 379-80 (N.D. Cal. 1991) ; *In re Hub Bus. Forms*, 146 B.R. 315, 319-21 (Bankr. D. Mass. 1992) ; *In re Roberts*, 46 B.R. 815, 849 (Bankr. D. Utah 1985) , *aff'd in relevant part, modified in part and rev'd in part on other grounds*, 75 B.R. 402, 407-09 (D. Utah 1987) ; *see also In re Pierce*, 809 F.2d 1356, 1362-63 (8th Cir. 1987) ; *In re Gray*, 64 B.R. 505, 507 (Bankr. E.D. Mich. 1986) ; *In re Estes*, 14 C.B.C.2d 58, 63-65, 57 B.R. 158, 162-63 (Bankr. N.D. Ala. 1986) ; *In re Patterson*, 53 B.R. 366, 371-72 (Bankr. D. Neb. 1985) ; *In re Marion Carefree Ltd. P'ship*, 171 B.R. 584, 590 (Bankr. D. Ohio 1994) ; *In re Smuggler's Beach Properties, Inc.*, 149 B.R. 740, 742 (Bankr. D. Mass 1993) ; *In re Eastern Charter Tours*, 167 B.R. 995, 996 (Bankr. D. Ga. 1994) ; *but see In re Lackawanna Med. Group, P.C.*, 323 B.R. 626 (Bankr. M.D. Pa. 2004) (questioning the distinction in *Roberts* that a law firm was not a creditor if law firm performed pre-petition services in contemplation of debtor's bankruptcy filing, but finding that a law firm was a creditor if pre-petition services were unrelated to bankruptcy).

A minority rule, allowing retention of professionals who are creditors of an estate, where the claim against the estate is small and where retention may confer a substantial benefit to the estate, has been adopted by several courts. *See, e.g., In re Microwave Prods. of Am., Inc.*, 94 B.R. 971, 974 (Bankr. W.D. Tenn. 1989) ; *In re Viking Ranches, Inc.*, 89 B.R. 113, 114-15 (Bankr. C.D. Cal. 1988) ; *In re Heatron, Inc.*, 2 C.B.C.2d 1054, 1056, 5 B.R. 703, 705 (Bankr. W.D. Mo. 1980) *In re Best Western Heritage Inn P'ship*, 79 Bankr. 736, 740-41 (Bankr. E.D. Tenn 1987) (attorney owed a fee for prebankruptcy work not related to filing Ch. 11 petition did not have an interest adverse to bankruptcy estate).

(n12)Footnote 12. *See, e.g., In re Gray*, 64 B.R. 505, 507 (Bankr. E.D. Mich. 1986) ; *In re Roberts*, 46 B.R. 815, 849 (Bankr. D. Utah 1985) , *aff'd in relevant part, modified in part and rev'd in part on other grounds*, 75 B.R. 402, 407-09 (D. Utah 1987) *In re Hub Bns. Forms*, 146 B.R. 315, 319-21 (Bankr. D. Mass. 1992) ; *In re Smuggler's Beach Properties, Inc.*, 149 B.R. 740, 742 (Bankr. D. Mass. 1993) . *But see In re Microwave Prods. of Am., Inc.*, 94 B.R. 971, 974-75 (Bankr. W.D. Tenn. 1989) (professional employed by the debtor prior to the commencement of the case, was "familiar with the products and operations of the debtors [sic] business, but does not have an interest 'materially adverse' to the estate"); *In re Viking Ranches, Inc.*, 89 B.R. 113, 115 (Bankr. C.D. Cal. 1988) (holding that the "*de minimus*" amount owed to an accounting firm, employed prior to commencement of the case, did not constitute an interest materially adverse to the estate); *In re Heatron, Inc.*, 2 C.B.C.2d 1054, 1056, 5 B.R. 703, 705 (Bankr. W.D. Mo. 1980) ("an attorney who has represented the debtor prior to the filing of the bankruptcy proceeding, who assisted in the preparation of the petition and who is a major creditor, without more, does not have an interest adverse to the debtor").

(n13)Footnote 13. *See, e.g., In re Roberts*, 46 B.R. 815, 849-50 (Bankr. D. Utah 1985) , *aff'd in relevant part, modified in part and rev'd in part on other grounds*, 75 B.R. 402, 407-09 (D. Utah 1987) ; *In re Pillowtex, Inc.*, 304 F.3d 246 (3rd Cir. 2002) ; *In re Lackawanna Med. Group. P.C.*, 323 B.R. 626, 634 (Bankr. M.D. Pa. 2004) ; *see also S. Bernstein, Collier Compensation, Employment and Appointment of Trustees and Professionals in Bankruptcy Cases*, P 1.05 (Matthew Bender).

(n14)Footnote 14. *See S. Bernstein, Collier Compensation, Employment and Appointment of Trustees and Professionals in Bankruptcy Cases*, P 1.05 (Matthew Bender) ("The waiver of the claim approach may prove to be impractical in that a professional person might increase the hourly rates charged for postpetition services in order to recapture at least some part of the waived claim. Although this tactic may be improper, it would be difficult to police.").

(n15)Footnote 15. 11 U.S.C. § 327(e).

(n16)Footnote 16. The debtors might also seek to retain other professionals to represent all the affiliated debtors.

(n17)Footnote 17. *See, e.g., In re Global Marine, Inc.*, 108 B.R. 998, 1004 (Bankr. S.D. Tex. 1987) , *appeal dismissed*, 108 B. R. 1007, 1009 (S.D. Tex. 1988) (existence of intercompany claim of approximately \$170,000,000 did not create impermissible conflict of interest); *In re Wheatfield Bus. Park LLC*, 286 B.R. 412, 415-416 (Bankr. D. Cal. 2002) (employment of counsel in three jointly administered cases poses potential conflict of interest and consent of creditors must be obtained; *In re Covenant Fin. Group of Am., Inc.*, 243 B.R. 450, 455 (no conflict of interest in attorney's dual representation of debtor and affiliates). *But see In re Amdura Corp.*, 121 B.R. 862, 867-69 (Bankr. D. Colo. 1990) (rejecting distinction between actual and potential conflicts and finding representation of six related corporate entities impermissible).

The question of whether a professional may represent affiliates often requires consideration of *section 327(c) of the Bankruptcy Code*, which relates to employment by, or representation of, a debtor and its creditors. Section 327(c) is discussed at P 9.08[2][a][iv] *infra*.

(n18)Footnote 18. *See, e.g., In re Rusty Jones, Inc.*, 134 B.R. 321, 343-44 (Bankr. N.D. Ill. 1991) ; *In re Kendavis Indus. Int'l, Inc.*, 91 B.R. 742, 751-57 (Bankr. N.D. Tex. 1988) ; *In re McKinney Ranch Assocs.*, 62 B.R. 249, 255-56 (Bankr. C.D. Cal. 1986) ; *In re Sambo's Rests., Inc.*, 20 B.R. 295, 307 (Bankr. C.D. Cal. 1982) ; *see also In re EWC, Inc.*, 138 B.R. 276, 284 (Bankr. W.D. Okla. 1992) (disqualifying counsel for simultaneous representation of debtor and

its sole shareholder due to adverse interests, but stating that such "[c]oncurrent representation ... is not per se a conflict of interest"); *In re TMA Assoc., Ltd.*, 129 B.R. 643, 649 (Bankr. D. Colo. 1991) (disqualifying counsel that represents general partners from representing partnership debtor because of the "totality of the circumstances," but refusing to adopt a "per se rule"--that says a Chapter 11 partnership/debtor's attorney cannot, under any circumstances or at any time, also represent one or more related persons or entities"); *In re Weaver Potato Chip Co.*, 243 B.R. 737, 741 (Bankr. D.Neb. 2000); *In re Grabill Corp.*, 113 Bankr. 966, 20 Bankr. Ct. Dec. 768, 771 (Bankr. N.D. Ill., 1990); *Skiba v. Union Station Dev. Corp.* (*In re Dascom, Inc.*), 180 B.R. 430, 431 (Bankr. D.Pa. 1995) .

(n19)Footnote 19. See, e.g., *In re Howell*, 148 B.R. 269, 270-72 (Bankr. S.D. Tex. 1992); *In re Huddleston*, 120 B.R. 399, 401-03 (Bankr. E.D. Tex. 1990); *In re Stamford Color Photo*, 98 B.R. 135, 138 (Bankr. D. Conn. 1989); *In re O'Connor*, 52 B.R. 892, 895-98 (Bankr. W.D. Okla. 1985); cf. *In re Lillian Laurence, Ltd.*, 136 B.R. 1, 4 (Bankr. D.D.C. 1992) (noting "split of authority over whether courts should draw distinctions between potential and actual conflicts of interest"). But see *In re Kendavis Indus. Int'l, Inc.*, 91 B.R. 742, 754 (Bankr. N.D. Tex. 1988) ("[t]he concept of potential conflicts is a contradiction in terms") (emphasis in original).

(n20)Footnote 20. 11 U.S.C. § 327(c).

(n21)Footnote 21. See, e.g., *In re BH & P, Inc.*, 949 F.2d 1300, 1314-17, 26 C.B.C.2d 37, 54-58 (3d Cir. 1991); *In re Green St.*, 132 B.R. 460, 462 (Bankr. D. Utah 1991), *aff'd sub nom. In re Interwest Bus. Equip., Inc.*, 23 F.3d 311, 31 C.B.C.2d 73 (10th Cir. 1994); *In re Greater Pottstown Cmty. Church of Evangelical Congregational Church*, 80 B.R. 706, 711 (Bankr. E.D. Pa. 1987); *In re Campbell Erskine Apothecary, Inc.*, 302 B.R. 169, 175 (Bankr. W.D.Pa. 2003); *In re Git-N-Go, Inc.*, 321 B.R. 54, 59-61 (Bankr. N.D.Okla. 2004); *Premier Farms, L.C.*, 305 B.R. 717, 720 (Bankr. N.D.Iowa 2003) .

The court in *Greater Pottstown* went even further in finding that "a prohibited apparent or actual conflict arises perforce when ... counsel for a debtor or DIP ... has represented a creditor in the past or, what is even more clearly objectionable, purports to represent a creditor in the same proceeding in which he represents the DIP." *Greater Pottstown, supra*, 80 B.R. 706, 711 .

(n22)Footnote 22. Compare *In re Dynamark, Ltd.*, 137 B.R. 380, 381 (Bankr. S.D. Cal. 1991) (permitting attorney to represent debtor in possession despite simultaneous representation of debtor's largest secured creditor on unrelated matters due to lack of actual conflict or adverse interest) and *In re Cenargo Int'l, Plc.*, 294 B.R. 571, 596-98 (Bankr. S.D.N.Y. 2003) with *In re American Printers & Lithographers, Inc.*, 28 C.B.C.2d 242, 246-49, 148 B.R. 862, 865-67 (Bankr. N.D. Ill. 1992) (denying debtor's application to employ counsel that also represents secured creditor of debtor in unrelated matters) and *In re Envirodyne Industries, Inc.*, 150 B.R. 1008, 1018-19 (N.D. Ill. 1993) .

(n23)Footnote 23. Cf. *In re Ochoa*, 74 B.R. 191, 194-95 (Bankr. N.D.N.Y. 1987) .

(n24)Footnote 24. Fed. R. Bankr. P. 2014(a).

(n25)Footnote 25. Fed. R. Bankr. P. 2014(a). A professional must also comply with Bankruptcy Rule 5002, which prohibits the employment of attorneys and other professionals who are relatives of the bankruptcy judge approving the employment, or who have been "so connected with" the judge or the United States trustee "as to render the appointment or employment improper." Bankruptcy Rule 5002(a) and (b).

(n26)Footnote 26. Fed. R. Bankr. P. 2014(a). Rule 2014 is a clear mandate for the disclosure of all actual and potential conflicts of interest. Under section 328(c), the court is authorized to deny allowance of compensation for services and reimbursement of expenses of a professional person employed pursuant to section 327 "if, at any time during such professional person's employment ... such professional person is not a disinterested person, or represents or holds an interest adverse to the interest of the estate with respect to the matter on which such professional person is employed." 11 U.S.C. § 328(c). In applying this section, courts often seem most disturbed by counsel's failure to

disclose conflicts of interest in a timely manner. *See, e.g., In re Royal Gorge Assocs.*, 77 B.R. 277 (Bankr. D. Colo. 1987) and *In re Big Rivers Elec. Corp.*, 233 B.R. 768, 786 (Bankr. W.D. Ky. 1999) reversed in part and remanded by 258 B.R. 673 and 252 B.R. 393 (Bankr. 10th Cir. 1998) ; *In re Granite Partners, L.P.*, 219 B.R. 22, 34-35 (Bankr. S.D.N.Y. 1998) . While disclosing potential and actual conflicts will not guarantee the safety of counsel's fees, prudent counsel should reveal all potential and actual conflicts as soon as they are known.

(n27)Footnote 27. Pursuant to *Fed. R. Bankr. P. 2014(a)*, the application and accompanying affidavit must be filed with the court and transmitted by the applicant to the United States trustee. *See also Fed. R. Bankr. P. 9034(d)*.

(n28)Footnote 28. 11 U.S.C. § 329(a); *Fed. R. Bankr. P. 2016(b)*; *see P 9.07[5] supra* for a discussion of the Rule 2016 Statement.

(n29)Footnote 29. *Cf. 11 U.S.C. §§ 327 and 328; Fed. R. Bankr. P. Rule 2014(a)*.

(n30)Footnote 30. *See generally* S. Bernstein, Collier Compensation, Employment and Appointment of Trustees and Professionals in Bankruptcy Cases, P 1.06 (Matthew Bender) (discussing various courts' approaches to retroactive approval of professional employment).

(n31)Footnote 31. Absent a showing of immediate and irreparable harm, a bankruptcy court cannot grant a professional's retention application within the 20 days after the petition date. *See Fed. R. Bankr. P. 6003(a)*. In certain districts, including the Southern District of New York, hearings on professional retention applications require longer notice periods than those dictated by the Bankruptcy Rules. In such districts, professionals may be retained on an interim basis in order than they may be compensated for post-petition work prior to final retention or in the event they are not retained on a final basis.

(n32)Footnote 32. *Fed. R. Bankr. P. 1007(a)(4), (c)*. *See also Interim Rule 1007(a)(5), (c)*. In the case of a motion for extension of time to file the schedules and statements pursuant to *Fed. R. Bankr. P. 1007(c)*, notice also must be provided to any examiner in the case. *Fed. R. Bankr. P. 1007(c)*.

(n33)Footnote 33. The debtors might seek to link an order for joint administration with a request for court approval of consolidation of cash management by the affiliated debtors. *See P 9.08[7] infra* for a discussion of cash management orders.

(n34)Footnote 34. *See 11 U.S.C. § 101(2); P 9.05 n.3 supra* (defining "affiliate").

(n35)Footnote 35. *Fed. R. Bankr. P. 1015(b)* provides:

If a joint petition or two or more petitions are pending in the same court by or against (1) a husband and wife, or (2) a partnership and one or more of its general partners, or (3) two or more general partners, or (4) a debtor and an affiliate, the court may order a joint administration of the estates.

Fed. R. Bankr. P. 1015(b) further provides that "[p]rior to entering an order the court shall give consideration to protecting creditors of different estates against potential conflicts of interest."

(n36)Footnote 36. The consolidation of two or more separate estates into a single estate would occur only if the court ordered the substantive consolidation of the separate bankruptcy cases. *See Advisory Committee Note to Fed. R. Bankr. P. 1015(b), reprinted in Vol. A Collier on Bankruptcy*, App. Pt. 2(c) (Matthew Bender 15th Ed. Revised).

(n37)Footnote 37. *See Advisory Committee Note to Fed. R. Bankr. P. 1015(b), reprinted in Vol. A Collier on Bankruptcy*, App. Pt. 2(c) (Matthew Bender 15th Ed. Revised).

(n38)Footnote 38. *Advisory Committee Note to Fed. R. Bankr. P. 1015(b), reprinted in Vol. A Colliers on*

Bankruptcy, App. Pt. 2(c) (Matthew Bender 15th Ed. Revised).

(n39)Footnote 39. Absent reason to believe that the court will not order joint administration, debtors that plan to file their petitions simultaneously should, to the extent they seek the same first-day relief, submit joint first-day motions. The case caption on such motions should include the names of all debtors.

(n40)Footnote 40. 11 U.S.C. § 362.

(n41)Footnote 41. See P 9.08[5][a] and [b] *infra* for a discussion of courts' responses to these motions.

(n42)Footnote 42. Section 104 of the Bankruptcy Code, enacted by the Bankruptcy Reform Act of 1994, provides for an automatic adjustment of dollar amounts in certain sections of the Bankruptcy Code, including section 507(a)(4), every three years beginning April 1, 1998 in order to reflect inflation. The effective date of the most recent increase in dollar amounts was April 1, 2007. In cases filed before April 1, 2007, the old amount (\$10,000) still applies.

Section 507(a)(4) also accords priority to unsecured claims for sales commissions earned by an individual or by a corporation with only one employee, acting as an independent contractor in the sale of goods or services for the debtor in the ordinary course of the debtor's business, earned within 180 days before the earlier of the date of the filing of the petition or the date of the cessation of the debtor's business, up to a maximum of \$10,950 per individual or corporation. The priority for claims for sales commissions earned by independent contractors applies only if, during the preceding 12 months, at least 75 percent of the amount that the individual or corporation earned by acting as an independent contractor in the sale of goods or services was earned from the debtor. 11 U.S.C. § 507(a)(4)(B).

(n43)Footnote 43. See, e.g., *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989) ; *In re Gulf Air, Inc.*, 112 B.R. 152 (Bankr. W.D. La. 1989) ; *In re Equalnet Comm. Corp.*, 258 B.R. 368, 370-71 (Bankr. S.D. Tex 2001) ; *In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. Mass. 1983) , *aff'd by Sobchak v. American Nat'l Bank & Trust Co.* (*In re Ionosphere Clubs, Inc.*) 17 F.3d 600 (2d Cir. 1994) .

(n44)Footnote 44. See, e.g., *In re Columbia Packing Co.*, 35 B.R. 447 (Bankr. D. Mass. 1983) ; see also *In re Quality Interiors, Inc.*, 24 C.B.C.2d 1823, 1830, 127 B.R. 391, 397 (Bankr. N.D. Ohio 1991) (noting that the court "often permits the payment of prepetition wages so that the debtor-in-possession may maintain an effective work force, especially where the amount of the payment is relatively small and where it appears that the wages being paid would ultimately qualify as priority claims"); *In re The Ground Round, Inc.*, 316 B.R. 423, 428 (Bankr. D. Mass. 2004) ; *In re CEI Roofing, Inc.*, 315 B.R. 50, 60-61 (Bankr. N.D. Tex. 2004) .

(n45)Footnote 45. Section 105(a) of the Code authorizes a court to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]." 11 U.S.C. § 105(a). Section 105 "codifies traditional equity powers of the bankruptcy court." *In re Amtol Corp.*, 14 C.B.C.2d 386, 388, 57 B.R. 724 (Bankr. N.D. Ohio 1986) ; *In re Evoli*, 258 B.R. 839 (Bankr. D. Fla. 2001) ("The equity powers of the court under § 105(a) are to carry out the provisions of the Bankruptcy Code").

(n46)Footnote 46. Section 507(a)(5) covers contributions to various employee benefit plans including insurance and pension plans. See, e.g., *In re Saco Local Dev. Corp.*, 711 F.2d 441, 8 C.B.C.2d 1093 (1st Cir. 1983) (priority payment of employee insurance premiums authorized); *Falcon Creditor Trust v. Blue Cross Blue Shield* (*In re Falcon Prods.*). 2007 Bankr. LEXIS 2562, 17 n. 2 (Bankr. D. Mo. 2007) .

(n47)Footnote 47. See *In re Ionosphere Clubs, Inc.*, 98 B.R. 174, 174-76 (Bankr. S.D.N.Y. 1989) ; *In re Equalnet Communs. Corp.*, 45 C.B.C.2d 887, 258 B.R. 368, 370-71 (Bankr. S.D. Tex. 2001) (approving payment of prepetition wage, medical benefit and business expense claims of active employees when payments were needed to protect debtor's estate).

Additionally, courts have recognized the dependence of employees on reimbursements for expenses and, relying on

section 105(a) of the Bankruptcy Code, have authorized payments on such prepetition claims to avoid economic hardship to the employees of chapter 11 debtors. *In re Chateaugay Corp.* 80 B.R. 279, 287 (S.D.N.Y. 1987) ; *In re CEI Roofing, Inc.*, 315 B.R. 50, 60-61 (N.D. Tex. 2004) .

(n48)Footnote 48. See *Miltenberger v. Logansport R. Co.*, 106 U.S. 286, 1 S. Ct. 140, 27 L. Ed. 117 (1882) ; *Dudley v. Mealey*, 147 F.2d 268, 271 (2d Cir. 1945) , cert. denied, 325 U.S. 873, 65 S. Ct. 1415, 89 L. Ed. 1991 (1945) ; *In re Eagle-Picher Indus., Inc.*, 124 B. R. 1021, 1023 (Bankr. S.D. Ohio 1991) (authorizing payments to toolmakers and noting that the "unique nature of the relationships here involved is important in reaching this conclusion"). But see *In re Kmart*, 359 F.3d 866 (7th Cir. 2004) (reversing bankruptcy court's order allowing debtor to pay prebankruptcy unsecured claims before confirmation of a chapter 11 plan); *In re Just for Feet, Inc.*, 242 B.R. 821, 826 (D. Del. 1999) ; *In re CoServ, LLC*, 273 B.R. 487, 502 (Bankr. N.D. Tex. 2002) ; *In re B&W Enterprises Inc.*, 713 F.2d 534 (9th Cir. 1983) .

(n49)Footnote 49. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005.

(n50)Footnote 50. 11 U.S.C. § 546(c)(1). Prior to the amendment, the creditor had either a 10-day window period after the insolvent debtor received the goods to make a written reclamation demand or 20 days if the 10-day window fell after the commencement of the bankruptcy case.

(n51)Footnote 51. See 11 U.S.C. § 546(c)(2) and 11 U.S.C. § 503(b)(9) (added by Pub. L. No. 109-8 (2005)).

(n52)Footnote 52. See 3 *Collier on Bankruptcy*, P 363.03[3] (Matthew Bender 15th Edition Revised) for a more detailed discussion of cash collateral.

(n53)Footnote 53. 11 U.S.C. § 363(c)(1).

(n54)Footnote 54. 11 U.S.C. § 363(c)(2).

(n55)Footnote 55. 11 U.S.C. § 363(c)(4).

(n56)Footnote 56. 11 U.S.C. § 363(a).

(n57)Footnote 57. 3 *Collier on Bankruptcy*, P 363.03[3] (Matthew Bender 15th Edition Revised).

(n58)Footnote 58. 3 *Collier on Bankruptcy*, P 363.03[3] (Matthew Bender 15th Edition Revised). Cash collateral includes cash over which an entity has a secured claim. Section 506(a) of the Bankruptcy Code designates as "secured claims" those claims subject to setoff. 11 U.S.C. § 506(a).

(n59)Footnote 59. See *Freightliner Mkt. Dev. Corp. v. Silver Wheel Freightlines, Inc.*, 823 F.2d 362, 368-69 (9th Cir. 1987) (implied consent insufficient to authorize use of cash collateral); *In re Rebel Rents, Inc.*, 307 B.R. 171, 183 (Bankr. C.D. Cal 2004) (debtor seeking to use cash collateral is required to obtain affirmative express consent of each entity with an interest in the cash collateral).

(n60)Footnote 60. *Fed. R. Bankr. P. 4001(d)*.

(n61)Footnote 61. *Fed. R. Bankr. P. 4001(d)(1)*; see also *Fed. Bankr. P. 9034(f)*. Notice of the motion and the objection deadline must be mailed to all parties upon whom service of the motion must be made and to such other parties as the court might direct. *Fed. R. Bankr. 4001(d)(2)*.

The 2000 Amendments to the Federal Rules of Bankruptcy Procedure amended Fed. Bankr. P. 4003(b) to replace the words "trustee" or "creditor" with "party in interest" to conform to section 522(l) which permits any party in interest to object to claimed exemptions. 2000 Amendment Advisory Committee Note.

(n62)Footnote 62. *Fed. R. Bankr. P. 4001(d)(2)*.

(n63)Footnote 63. *Fed. R. Bankr. P. 4001(d)(3)*.

(n64)Footnote 64. *Fed. R. Bankr. P. 4001(d)(3)*.

(n65)Footnote 65. *See Fed. R. Bankr. P. 4001(b)*. If, after moving pursuant to *Fed. R. Bankr. P. 4001(b)* for authorization to use cash collateral, the debtor obtains an agreement in settlement of the motion, *Fed. R. Bankr. P. 4001(d)(4)* should be consulted. *Fed. R. Bankr. P. 4001(d)(4)* provides:

[t]he court may direct that the procedures prescribed in paragraphs (1), (2), and (3) of this subdivision shall not apply and the agreement may be approved without further notice if the court determines that a motion made pursuant to subdivisions (a), (b), or (c) of this rule was sufficient to afford reasonable notice of the material provisions of the agreement and opportunity for a hearing.

The 1991 Advisory Committee Note to the Rule explains that it was added:

to avoid the necessity of further notice and delay for the approval of an agreement in settlement of a motion for relief from an automatic stay, to prohibit or condition the use, sale, or lease of property, for use of cash collateral, or for authority to obtain credit

Pursuant to *Fed. R. Bankr. P. 4001(d)(4)*, further notice of an agreement need not be given when the entities entitled to notice received sufficient notice of the scope of the proposed agreement in the motion papers and have had an opportunity to be heard. In the event that the motion papers have not afforded sufficient notice and opportunity for a hearing, approval of the settlement agreement cannot be obtained unless the requirements of *Fed. R. Bankr. P. 4001(d)(1)-(3)* are met. *See* 1991 Advisory Committee Note to *Rule 4001(d)(4)*. As an example of the operation of the Rule, the Advisory Committee noted:

if a trustee makes a motion to use cash collateral and proposes in the original motion papers to provide adequate protection of the interest of the secured party by granting a lien on certain equipment, and the secured creditor subsequently agrees to terms that are within the scope of those proposed in the motion, the court may enter an order approving the agreement without further notice if the entities that received the original motion papers have had a reasonable opportunity to object to the granting of the motion to use cash collateral.

(n66)Footnote 66. *See Fed. R. Bankr. P. 4001(d)*.

11 U.S.C. § 363(e). The debtor, however, has the burden of proof on adequate protection. 11 U.S.C. § 363(p)(1).

(n67)Footnote 67. *Fed. R. Bankr. P. 9014* governs contested matters.

(n68)Footnote 68. *Fed. R. Bankr. P. 4001(b)(1)* and *9034(f)*. Notice of hearing must be given to all parties on whom service of the motion is required and to such other entities as the court may direct. *Fed. R. Bankr. P. 4001(b)(3)*.

(n69)Footnote 69. Although *section 363(c)(2) of the Code* provides that the debtor in possession may not use cash collateral unless the court "after notice and a hearing authorizes such use," *section 102 of the Code* provides:

(1) "after notice and a hearing", or a similar phrase--

(A) means after such notice as is appropriate in the particular circumstances, and such opportunity for a hearing as is appropriate in the particular circumstances; but

(B) authorizes an act without an actual hearing if such notice is given properly and if--

(i) such a hearing is not requested timely by a party in interest; or

(ii) there is insufficient time for a hearing to be commenced before such act must be done, and the court authorizes such act.

11 U.S.C. § 102(1).

(n70)Footnote 70. *Fed. R. Bankr. P. 4001(b)(2)*.

(n71)Footnote 71. *Fed. R. Bankr. P. 4001(b)(2)*. The movant may combine the notice of the preliminary and the final hearing. 1987 Advisory Committee Note to *Fed. R. Bankr. P. 4001(b)*.

(n72)Footnote 72. *See, e.g., Owens-Corning Fiberglas Corp. v. Ctr. Wholesale, Inc. (In re Ctr. Wholesale, Inc.)*, 759 F.2d 1440, 1449-50, 12 C.B.C.2d 1107, 1118-19 (9th Cir. 1985) (one-day written notice to ten largest creditors insufficient when no final hearing scheduled to reconsider order); *In re Sheehan*, 38 B.R. 859, 861, 863 (*Bankr. D.S.D. 1984*) (72-hour notice adequate when final hearing scheduled approximately 121 days later); *In re Anderson-Walker Indus., Inc.*, 1 C.B.C.2d 831, 833, 3 B.R. 551, 553 (*Bankr. C.D. Cal. 1980*) (telephonic notice of hearing to be held two days after chapter 11 filing deemed sufficient; the court noted that debtor had been negotiating with objecting creditor for at least a week before filing in an attempt to obtain consent to use of cash collateral); *In re Sullivan Ford Sales*, 1 C.B.C.2d 397, 403-04, 2 B.R. 350, 354-55 (*Bankr. D. Me. 1980*) (one-day telephonic notice to a few holders of secured and unsecured claims and notice to creditors' committee appointed one hour before hearing insufficient when debtor should have anticipated its financial needs 12 days earlier when it first filed for bankruptcy); *Western Auto Supply Co. v. Savage Arms (In re Savage Arms)*, 43 F.3d 714, 720-21 (1st Cir. 1994) ("Notice" means such notice as is appropriate in the particular circumstances); *see also* 11 U.S.C. § 363(c)(3).

(n73)Footnote 73. 11 U.S.C. § 363(c)(3).

(n74)Footnote 74. *Fed. R. Bankr. P. 4001(b)(2)*.

(n75)Footnote 75. 11 U.S.C. § 363(e); *see Fed. R. Bankr. P. 4001(a) and (d)* relating to requests to condition the use, sale or lease of property pursuant to section 363(e).

(n76)Footnote 76. The creditor has the burden of proving the "validity, priority or extent" of its interest in the property. 11 U.S.C. § 363(p)(2). The debtor in possession has the burden of proof on the issue of adequate protection. 11 U.S.C. § 363(p)(1). Section 361 provides examples of what constitutes "adequate protection." Examples include: periodic cash payments or the provision of additional or replacement liens to compensate for the decrease in value to the entity's interest in the property. 11 U.S.C. § 361.

(n77)Footnote 77. *See* 11 U.S.C. § 365(c)(2).

(n78)Footnote 78. 11 U.S.C. § 364(a).

(n79)Footnote 79. 11 U.S.C. §§ 503(b) and 507(a)(2). The expenses allowable under section 503(b)(1)(A) are "the actual, necessary costs and expenses of preserving the estate." 11 U.S.C. § 503(b)(1)(A).

(n80)Footnote 80. "A mere administrative expense is the lowest priority one can receive for postpetition debt. It is usually confined to trade suppliers, and even they often demand COD until the debtor can once again prove

creditworthy." Rochelle, *Post-Filing Loans to the Chapter 11 Debtor: Good Money After Bad*, 107 *Banking L.J.* 344, 345 (1991) ["Rochelle"].

(n81)Footnote 81. See, e.g., *In re Kenney's Franchise Corp.*, 6 C.B.C.2d 1270, 1272, 21 B.R. 461 (Bankr. W.D. Va. 1982) (debt service charge and interest charges were outside the ordinary course of business and therefore disallowed); see also Landers & Dunwoody, *Debtor-in-Possession Financing*, Real Estate Workouts and Bankruptcies, 181, 184 (Wiley 1990).

(n82)Footnote 82. 11 U.S.C. § 364(b).

(n83)Footnote 83. See Rochelle, n.80 *supra*, at 346.

(n84)Footnote 84. 11 U.S.C. § 364(c).

(n85)Footnote 85. 11 U.S.C. § 364(d)(1).

(n86)Footnote 86. 11 U.S.C. § 364(d)(1)(A). Courts vary on the degree of effort they require the debtor to exert to obtain alternative financing. See *In re Reading Tube Indus.*, 16 C.B.C.2d 815, 818, 72 B.R. 329 (Bankr. E.D. Pa. 1987) ("Courts have found 20 attempts and 2 attempts to be sufficient under the particular circumstances of each case. ...").

(n87)Footnote 87. 11 U.S.C. § 364(d)(1)(B); see *In re Chicago, Mo. & W. Ry. Co.*, 109 B.R. 308 (N.D. Ill. 1989) , *appeal dismissed*, 899 F.2d 17 (7th Cir. 1990) (in railroad reorganization case, district court reversed bankruptcy court's decision authorizing priming of the lien on the ground that prepetition creditors were not adequately protected, despite the bankruptcy court's finding that refusal of authorization would result in cessation of operations and liquidation of debtor); *In re Plabell Rubber Products*, 137 B.R. 897, 899-900 (Bankr. N.D. Ohio 1992) (priming of lien not authorized because debtor had not met its burden of proving adequate protection).

(n88)Footnote 88. See *Fed. R. Bankr. P. 4001(c)*. If the debtor enters into an agreement with an entity whereby the entity authorizes the priming of its lien, the debtor must submit to the bankruptcy court a motion for approval of the agreement. See *Fed. R. Bankr. P. 4001(d)(1)*.

If, after service of a motion for authorization of financing pursuant to *Fed. R. Bankr. P. 4001(c)*, the debtor enters into an agreement in settlement of the motion, *Fed. R. Bankr. P. 4001(d)(4)* should be consulted. See n.64 *supra* for a discussion of *Fed. R. Bankr. P. 4001(d)(4)*.

(n89)Footnote 88a. See *Fed. R. Bankr. P. 2001(c)(1)*.

(n90)Footnote 88b. See *id.* The 2007 Amendments to the Federal Rules of Bankruptcy Procedure amend Fed. Bankr. P. 4003(c) and (d). The objective of the modifications was to "enhance the ability of the court and interested parties to find the relevant provisions and understand the nature of the relief requested." American Bankruptcy Institute Bankruptcy Litigation Committee Newsletter, March 2008, Volume 5, Number 2 *available at* <http://www.abiworld.org/committees/newsletters/litigation/vol5num2/Recent.html>.

(n91)Footnote 89. See 1987 Advisory Committee Note to Bankruptcy Rule 4001(c).

(n92)Footnote 90. See *id.* In addition, the debtor should request that the court authorize the debtor to execute all instruments necessary to perfect the creditor's interest.

(n93)Footnote 91. *Fed. R. Bankr. P. 4001(c)(1)* and 9034(f). Notice of hearing must be given to the parties on whom service of the motion is required and to such other entities as the court may direct. *Fed. R. Bankr. 4001(c)(3)*.

(n94)Footnote 92. *Fed. R. Bankr. P. 4001(c)(2)*.

(n95)Footnote 93. *Fed. R. Bankr. P. 4001(c)(2)*.

(n96)Footnote 94. *Fed. R. Bankr. P. 4001(c)(2)*.

(n97)Footnote 95. *See, e.g., In re Adamson Co.*, 29 B.R. 937, 941 (Bankr. E.D. Va. 1983) (less than 24 hours' notice to ten largest creditors, the primary secured creditors and the United States trustee inadequate notwithstanding probability of temporary closing of debtor's plant); *Sullivan Ford*, n.71 *supra*, 1 C.B.C.2d 397, 406 (*ex parte* relief available only "upon a sufficient showing that immediate and irreparable injury, loss, or damage will result to the moving party or to the reorganization effort before adverse parties or their counsel can be notified") (*emphasis in original*); *see also Yukos Oil Co. v. Russian Fed'n (In re Yukos Oil Co.)* 320 B.R. 130, 134 (Bankr. S.D. Tex 2004) .

(n98)Footnote 96. When the debtor's prepetition lenders are providing the postpetition financing facility, the lenders may also try to condition the postpetition facility on the receipt of adequate protection payments and the validation of prepetition claims. Courts have refused to authorize the debtor in possession financing in certain cases because of such conditions. *See, e.g., In re Tenney Village Co.*, 104 B.R. 562, 567-70 (Bankr. D.N.H. 1989) ; *In re Mid-State Raceway, Inc.*, 323 B.R. 40, 59-60 (Bankr. N.D. NY. 2005) (bankruptcy court will not authorize financing that grants the lender excessive control over the debtor or its assets as to unduly prejudice the rights of other parties in interest).

(n99)Footnote 97. *Compare e.g., In re Monach Circuit Indus., Inc.*, 11 C.B.C.2d 312, 316, 41 B.R. 859, 862 (Bankr. E.D. Pa. 1984) (Bankruptcy Code does not permit cross-collateralization) and *Bland v. Farmworker Creditors*, 308 B.R. 109 (Bankr. D.GA. 2003) with *In re Beker Indus. Corp.*, 58 B.R. 725, 741-43 (Bankr. S.D.N.Y. 1986), *In re Robinson*, 217 B.R. 527, 531 (Bankr. D.Tex. 1998) (cross-collateralization permitted) , *rev'd*, 89 B.R. 336 (S.D.N.Y. 1988) and *In re Keystone Camera Prods. Corp.*, 126 B.R. 177 (Bankr. D.N.J. 1991) ; *See also Tenney*, n.96 *supra*, 104 B.R. 562, 569-70 ; *In re Ames Dep't Stores, Inc.*, 22 C.B.C. 1500, 22 C.B.C.2d 1500, 115 B.R. 34, 39-40 (Bankr. S.D.N.Y. 1990) (surveying authority on cross-collateralization).

In *In re Vanguard Diversified, Inc.*, 31 B.R. 364 (Bankr. E.D.N.Y. 1983) , the court proposed the following four-pronged test for determining whether to permit cross-collateralization: (1) the financing is essential to the debtor's survival; (2) no alternative financing is available "on acceptable terms"; (3) the proposed lender will not extend credit without such cross-collateralization; and (4) the financing is "in the best interests of the general creditor body." *Id.*, 31 B.R. 364, 366 *followed by In re Roblin Industries, Inc.*, 52 B.R. 241, 244-45 (Bankr. W.D.N.Y. 1985) .

(n100)Footnote 98. Until 1992, none of the Courts of Appeals had directly ruled on the permissibility of cross-collateralization. Several courts faced with appeals of financing orders that contained cross-collateralization provisions had discussed the permissibility of cross-collateralization under the Code, but disposed of the appeals without deciding the issue.

For example, both the Courts of Appeal for the Sixth and Ninth Circuits found appeals of orders containing cross-collateralization provisions to be moot under *section 364(e) of the Code* and, therefore, did not have to decide whether cross-collateralization was permissible. *See In re Ellingsen MacLean Oil Co.*, 834 F.2d 599, 602, 17 C.B.C.2d 1402, 1406 (6th Cir. 1987) (financing order included provision prohibiting challenge to lender's prepetition security interests), *cert. denied sub nom. Unsecured Creditors' Comm. v. First Nat'l Bank & Trust Co.*, 488 U.S. 817, 109 S. Ct. 55, 102 L. Ed. 2d 33 (1988) ; *In re Adams Apple, Inc.*, 829 F.2d 1484, 1488 n.6, 1489, 17 C.B.C.2d 1132, 1137-38 (9th Cir. 1987) .

Section 364(e) of the Code provides as follows:

The reversal or modification on appeal of an authorization under this section to obtain credit or incur debt, or of a grant under this section of a priority or a lien, does not affect the validity of any debt so incurred, or any priority or lien so granted, to an entity that extended such credit in good faith, whether or

not such entity knew of the pendency of the appeal, unless such authorization and the incurring of such debt, or the granting of such priority or lien, were stayed pending appeal.

11 U.S.C. § 364(e).

In a later case, the Court of Appeals for the Ninth Circuit again declined to rule on whether cross-collateralization is permissible, finding that the issue had not been presented to or decided by the bankruptcy court. *See In re Sun Runner Marine, Inc.*, 945 F.2d 1089, 1094-95, 25 C.B.C.2d 1054, 1062 (9th Cir. 1991) .

In *In re Texlon Corp.*, the Second Circuit held that the financing order authorizing cross-collateralization should not have been granted *ex parte* and, therefore, did not have to decide whether cross-collateralization would ever be permissible. *In re Texlon Corp.*, 596 F.2d 1092, 1098 (2d Cir. 1979) (case decided under Bankruptcy Act, but court reviews relevant provisions of Bankruptcy Code).

For a discussion of the views on cross-collateralization expressed by these courts, see Tabb, *Requiem for Cross-Collateralization*, 2 J. Bankr. L. & Prac. 109, 114-15, 132-37, 145-48 (1993) ["Tabb"] and Delaware Journal of Corporate Law, 27 Del. J. Corp. L. 759 (2004).

(n101)Footnote 99. 963 F.2d 1490, 27 C.B.C.2d 277 (11th Cir. 1992) .

(n102)Footnote 100. 963 F.2d 1490, 1496, 27 C.B.C.2d 277, 285 . Based on that conclusion, the court found that section 364(e) of the Code did not apply and the appeal was not moot. *Id.*

For a more detailed discussion of Saybrook and its impact, see Tabb, n.98 *supra* ; Gebbia & Oscar, Saybrook Manufacturing: Is Cross-Collateralization Moot?, 2 J. Bankr. L. & Prac. 163 (1993).

(n103)Footnote 101. Saybrook, n.99 *supra* , 963 F.2d 1490 , 1494-95, 27 C.B.C.2d 277, 283 . The court stated that "sections 364(c) & (d) apply only to future-- i.e., postpetition--extensions of credit. They do not authorize the granting of liens to secure prepetition loans." *Id.* 963 F.2d 1490 at 1495 .

(n104)Footnote 102. *Id.*, 963 F.2d 1490 at 1496 .

(n105)Footnote 103. *Id.*

(n106)Footnote 103a. See Venture Lighting International, Inc., *et al.*, Northern District of Illinois case Nos. 03-5256 through 03-5261, Final Order (March 13, 2003; *but see* Murphy Marine Services, Inc., *et al.*, District of Delaware case Nos. 01-00926 through 01-00950, Final Order (July 12, 2001).

(n107)Footnote 104. See, e.g., *In re Charter Co.*, 778 F.2d 617, 621-22 (11th Cir. 1985) (affirming district court order determining that cash management order entered by bankruptcy court was interlocutory and denying leave to appeal from the order) , *rev'd on other grounds*, 113 B.R. 725, 1990 U.S. Dist. LEXIS 4621 (M.D. Fla. 1990) ; see e.g., *In re Enron Corp.*, 279 B.R. 671, 692-95 (Bankr. S.D.N.Y. 2002) (cash management order adequately alleviates creditors' concern about debtor's cash management).

(n108)Footnote 105. *But see In re Charter Co.*, 778 F.2d 617, 620 (bankruptcy court allowed the inclusion of nondebtor affiliates in the cash management system, but placed several restrictions on the debtors) , *rev'd on other grounds*, 113 B.R. 725, 1990 U.S. Dist. LEXIS 4621 (M.D. Fla. 1990) .

(n109)Footnote 106. *But see id.*

(n110)Footnote 107. *But see id.*

(n111)Footnote 108. For example, in the chapter 11 case of Pan Am Corporation, the bankruptcy court authorized a sale of assets to United Air Lines, Inc. ("UAL") in exchange for a "substantial infusion of cash" and a joint marketing arrangement two days after the case had commenced. *In re Pan Am Corp.*, Case Nos. 91B 10080-10087 (Bankr. S.D.N.Y. January 8, 1991) (Order Pursuant to *Sections 365(a)* and *363(b) of the Bankruptcy Code* Authorizing the Assumption of Certain Executory Contracts by and Among Pan Am Corporation, Pan American World Airways, Inc. and United Air Lines, Inc. and Sale of Assets Thereunder). Bankers Trust Company agreed to provide debtor-in-possession financing to Pan Am if the court approved the sale to UAL and UAL agreed to guarantee one-third of the financing. *Id.* (Verified Motion for an Order Authorizing Debtors to Obtain Secured Post-Petition Financing Pursuant to *11 U.S.C. § 364(c)*). More recently, in the chapter 11 cases of *In re Lehman Brothers Holdings Inc., et al.* (Case No. 08-13555, Bankr. S.D.N.Y., September 20, 2008) (Order under *11 U.S.C. §§ 105(a)*, *363*, and *365* and *Federal Rules of Bankruptcy Procedure 2002, 6004* and *6006* Authorizing and Approving (a) the Sale of the Purchased Assets Free and Clear of Liens and Other Interests and (b) Assumption and Assignment of Executory Contracts and Unexpired Leases [docket no. 258]), *In re Chrysler LLC, et al.* (Case No. 09-50002, *In re Old Carco LLC, et al* (f/k/a Chrysler LLC, et al.), Bankr. S.D.N.Y., June 1, 2009) (Order (I) Authorizing the Sale of Substantially All of the Debtors' Assets Free and Clear of all Liens, Claims, Interests and Encumbrances, (II) Authorizing the Assumption and Assignment of Certain Executory Contracts and Unexpired Leases in Connection Therewith and Related Procedures and (III) Granting Related Relief [docket no. 3232]) and *In re General Motors Corporation, et al.*, (Case No. 09-50026, *In re Motors Liquidation Company, et al* (f/k/a General Motors Corp., et al., Bankr. S.D.N.Y., July 5, 2009) Order (I) Authorizing Sale of Assets Pursuant to Amended and Restated Master Sale and Purchase Agreement; (II) Authorizing Assumption and Assignment of Certain Executory Contracts and Unexpired Leases in Connection with the Sale; and (III) Granting Related Relief [docket no. 2968]), sales of substantial have been approved on an expedited basis. In the cases of Chrysler LLC and General Motors Corporation, substantially all of the assets were approved within 45 days after the applicable petition date and in the case of Lehman Brothers Holdings Inc., a sale of a substantial portion of the debtors' assets was approved within one week of the petition date.

(n112)Footnote 109. *11 U.S.C. § 363(b)(1)*; see also n.68 *supra* regarding the meaning of "notice and hearing."

(n113)Footnote 110. *Fed. R. Bankr. P. 2002(c)(1)*. See *Interim Rule 2002(c)(1)*, which requires that notice of a sale or lease of personally identifiable information under *section 363(b)(1)(A) or (B) of the Bankruptcy Code* include a statement as to whether the transaction is consistent with a policy prohibiting the transfer of the information.

(n114)Footnote 111. *Fed. R. Bankr. P. 2002(a)(2)*, *2002(i)* and *9034(a)*; see also *Fed. R. Bankr. P. 2002(k)*. *Rule 2002(j)* should be consulted for the requirements relating to notices to the United States. In addition, *Fed. R. Bankr. P. 5003(e)*, amended effective December 1, 2000, provides a source where debtors, their attorneys and other parties may go to determine whether the United States or the state or territory in which the court is located has filed a statement designating a mailing address for notice purposes.

(n115)Footnote 112. See *Fed. R. Bankr. P. 2002(a)(2)*, *2002(i)*. Pursuant to *Fed. R. Bankr. P. 2002(i)*, the court may order that notice be transmitted to the United States trustee and mailed only to the committees elected pursuant to *section 705* or appointed under *section 1102* and to those creditors and security holders requesting that all notices be sent to them. However, when a sale or lease of substantial assets is proposed, the prospective buyer or lessee may not agree to a request for modification of the notice requirements.

(n116)Footnote 113. See *Fed. R. Bankr. P. 6003(b)*.

(n117)Footnote 114. However, in cases filed on or after October 17, 2005, if the debtor proposes to sell personally identifiable information about individuals, *section 363(b)(1)* provides that certain requirements must be met. See also *Interim Rule 6004(g)*. To the extent that the debtor wishes to sell property free and clear of encumbrances, *section 363(f) of the Bankruptcy Code* and *Fed R. Bankr. P. 6004(c)* must be consulted.

(n118)Footnote 115. See *11 U.S.C § 363(m)* (providing that the reversal or modification on appeal of authorization

under section 363(b) or (c) of sale or lease of property does not affect the validity of sale or lease under such authorization to an entity that purchased or leased in good faith, whether or not the entity knew of the pendency of appeal, unless authorization and sale or lease were stayed pending appeal).

(n119)Footnote 116. *11 U.S.C. § 363(e); see Fed. R. Bankr. P. 4001(a) and (d)* relating to requests to prohibit or condition the use, sale or lease of property pursuant to section 363(e).



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P 9.09 Prefiling Conferences.

In preparing for a chapter 11 filing, counsel for the debtor should assess the need for a prefiling conference with the clerk of the bankruptcy court or an employee of the clerk's office. Cooperation with the clerk's office will help to ensure the smooth operation of a chapter 11 case. The clerk's office may have preferences (and/or requirements) relating to the formatting, binding, copying and filing of documents, conformance with which will advance the cooperative relationship. A prefiling conference held on a "no-names" or confidential basis may be a useful way for the debtor's counsel to ascertain any such preferences or requirements.

A prefiling conference with the clerk's office may be particularly important in the case of a large corporate debtor whose bankruptcy filing will attract public attention. Particularly if the case will impose substantial or unique burdens on the clerk's office, advance notice to and consultation with the clerk would be advisable. Special procedures for the handling of administrative matters that may be necessary to ensure the smooth operation of the case should be worked out in advance of the filing date. For example, if the case will involve large numbers of creditors, special arrangements for the noticing of creditors and the fielding of creditor inquiries should be discussed. Such arrangements may include the employment of an outside claims agent,ⁿ¹ and the establishment of special telephone or electronic mail systems to handle inquiries.

Counsel for the debtor should also consider whether a prefiling conference with the United States trustee or a member of the United States trustee's staff would be advisable.ⁿ² The United States trustee is responsible for the supervision of administration of chapter 11 cases.ⁿ³ Pursuant to *section 307 of the Bankruptcy Code*, the United States trustee "may raise and may appear and be heard on any issue in any case or proceeding" under title 11.ⁿ⁴ Accordingly, the United States trustee will be a presence throughout any chapter 11 case.ⁿ⁵

Consultation with the United States trustee in advance of the bankruptcy filing, preferably on a confidential or "no-names" basis, might be suggested for a number of reasons. First, cooperation with the office of the United States trustee, as with the clerk's office, should facilitate the smooth commencement of the chapter 11 case. In matters of case administration, the United States trustee will have certain preferences or requirements, compliance with which will be advisable, if not mandatory. For example, virtually every United States trustee has guidelines for the operation of chapter 11 cases which impose upon the debtor such obligations as the duty to file periodic operating reports. A prefiling conference or, at a minimum, inquiry into the United States trustee's guidelines, will enable the debtor to meet its obligations from the start of the case.ⁿ⁶

Second, since the United States trustee has the right to be heard on any issue in a bankruptcy case, the debtor's counsel may find it useful to acquaint the United States trustee with the debtor's business and circumstances and to discuss any special needs that are foreseen for the debtor's bankruptcy case. Moreover, the debtor invariably will need some relief from the court on the filing date. It is advisable to submit the motion papers to the United States trustee for review and request that the trustee signify that he or she has "no objection" to the relief requested.ⁿ⁷

Finally, debtor's counsel may find it useful to consult with the United States trustee before the filing on the issue of professionals' fees. A primary concern of the United States trustee is the retention and compensation of professionals. The United States trustee will review all fee applications and, therefore, it is wise to understand the trustee's views on compensation in advance of incurring significant fees.ⁿ⁸

FOOTNOTES:

(n1)Footnote 1. See P 9.07[6][a] *supra* for a discussion of claims agents.

(n2)Footnote 2. The statutory authority for the United States trustee is found in 28 U.S.C. §§ 581-589b.

(n3)Footnote 3. See 28 U.S.C. § 586 (listing the duties of a United States trustee). Among those issues that generally are most important to the United States trustee are notice, retention of professionals, review of fee requests, investment of estate funds and general compliance with the provisions of the Bankruptcy Code, the Bankruptcy Rules and applicable local bankruptcy rules. See 1 *Collier on Bankruptcy*, P 6.07[1] (Matthew Bender 15th Edition Revised).

(n4)Footnote 4. 11 U.S.C. § 307.

(n5)Footnote 5. The extent of the United States trustee's involvement in a given case will be influenced by the level of creditor involvement. In the case of a large corporate debtor, the level of the United States trustee's involvement may decrease after the formation of the creditors' committee.

(n6)Footnote 6. At least one court has found that a failure to comply with the United States trustee's operating guidelines may justify the appointment of a trustee pursuant to *section 1104 of the Bankruptcy Code* if such failure results in keeping the debtor's creditors uninformed of the debtor's financial position. See *In re Denrose Diamond*, 49 B.R. 754, 759-60 (Bankr. S.D.N.Y. 1985) but see *In re Marvel Entertainment Group*, 140 F.3d 463, 471 (3rd Cir. 1998) ("appointment of a trustee should be the exception rather than the rule").

(n7)Footnote 7. Debtor's counsel should request that the United States trustee document his or her "no objection" position by signing statements to that effect on the proposed first-day orders to be submitted to the bankruptcy court.

(n8)Footnote 8. With respect to compensation, the United States trustee will require detailed time records to support all attorneys' fees requests. To minimize the chance of United States trustee objections to the documentation supporting its fee applications, the debtor's counsel should ascertain the trustee's time-keeping standards and be prepared to comply with them immediately upon the filing of the petition. See A. Resnick, *Bankruptcy Practice and Strategy*, P 12.02[2][c] (WGL 1987 & Supp. 1991).



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P 9.10 Public Relations.

[1] Prefiling Communications.

Prior to the bankruptcy filing, it may be advisable or necessary for the debtor to communicate with certain third parties regarding its circumstances and filing plans.ⁿ¹ If the debtor operates in a regulated industry, it probably will be required to consult with its regulators prior to filing a bankruptcy petition.

If the debtor's stock is publicly-traded, the debtor must notify any exchanges on which its securities are traded that it plans to file a bankruptcy petition.ⁿ² The exchanges may halt trading of the company's stock immediately before the scheduled filing to give the company enough time to make the announcement of the bankruptcy filing.ⁿ³

Prefiling notification of certain of the debtor's employees also is necessary. Indeed, a major task in the preparation period is to fully advise the debtor's key employees of the duties they will have and the restrictions that will be imposed on the company once the chapter 11 petition is filed. Other constituencies to whom the debtor might consider providing advance notice of its filing plans include key suppliers, major stockholders, affiliates, lenders and labor unions. Prefiling notification may further the debtor's interest in ensuring the future cooperation of such important constituencies.

[2] Notification of the Filing.

With respect to providing notice of the actual bankruptcy filing, the debtor and its counsel must be concerned about relations with the debtor's own employees, the public, regulatory agencies and interested third parties.

Large companies often employ outside firms to advise them about public relations, prepare necessary notices and releases, and set up appropriate procedures to handle inquiries.ⁿ⁴ These companies delegate the public relations duties to an outside firm instead of relying on their in-house communications departments for a number of reasons. First, due to its lack of experience in dealing with bankruptcy, an in-house communications department may be less effective than an agency that specializes in providing public relations services for chapter 11 debtors.ⁿ⁵ Also, because corporate communications departments are often scaled-down during cutbacks, the in-house department may be inadequately staffed to meet the company's public relations needs.ⁿ⁶ Finally, the need for objectivity in the public relations process may not be met by those directly affected by the bankruptcy filing.ⁿ⁷

[a] Employees.

The debtor should make efforts to ensure that its employees learn of the bankruptcy filing from the company itself, rather than from media reports of the event. As noted above, prefiling notification of key employees is necessary and advance notification to all employees may be advisable in certain circumstances. At a minimum, the debtor and its counsel should prepare, for distribution on the filing date to all of the debtor's employees, a notice that advises the employees that the company has filed under chapter 11.

The notice to employees should address the effect of the filing on the employees personally (*e.g.*, wages, benefits, continued employment) and on the operation of the company. The notice should apprise employees of the restrictions imposed by the Bankruptcy Code on the company's freedom of action, including restrictions on business transactions outside the ordinary course and the prohibition against payment of prepetition debts. Further, the employees should be informed about the banking and bookkeeping requirements that apply to a debtor in possession. When the debtor is a member of a corporate group, the notice should advise of the need to segregate scrupulously the assets and liabilities of each company. Specific notices geared to the operation of particular departments within the company may also be necessary.

[b] The Public.

A company whose securities are publicly-traded will be required to issue a release advising the public of the commencement of its bankruptcy case.ⁿ⁸ In the case of a closely-held company, the advisability of issuance of a press release will depend on the debtor's particular circumstances. For example, a press release is suggested when the debtor is a major employer or is involved in a service industry.ⁿ⁹

In addition to the press release, or in cases in which a press release is not warranted, the debtor should consider whether it will communicate directly with certain constituencies by way of letters, notices (electronic or otherwise) or even emails or phone calls. Providing notice to suppliers, stockholders, customers, labor unions and other third parties may be a means of reassuring such parties of the continuity of the debtor's business.

In addition to arranging for the issuance of a press release or other general notice and any individual notices, the debtor should establish a system to deal with inquiries from the public. Prior to the filing, the debtor should designate a spokesperson (or spokespersons) to deal with inquiries. The debtor should prepare the spokesperson for the likely questions and appropriate answers, and notify employees that all inquiries are to be referred to the spokesperson. Debtor's counsel should work with the debtor in preparing the spokesperson to respond to inquiries and should be prepared to field questions referred by the spokesperson. The debtor may also create a website containing information related to the case and key documents filed in the case. The debtor will usually include a link to this website on the debtor's regular website.

[c] Regulatory Agencies.

Certain notification requirements are imposed on all publicly-traded companies. In addition to issuing a press release, a public company must within 4 business days after the filing, report its chapter 11 filing to the Securities and Exchange Commission on the Form 8-K.ⁿ¹⁰ Further, as noted above,ⁿ¹¹ a publicly-traded company must comply with the requirement that it give advance notice of its bankruptcy filing to any exchanges on which its stock is traded.

Any company operating in a regulated industry should consult the rules of the relevant regulatory agency.

[d] Interested Third Parties.

The Bankruptcy Rules specifically require the debtor to provide notice of its bankruptcy filing to certain other third parties. *Federal Rule of Bankruptcy Procedure 2015(a)(4)* provides that the trustee or debtor in possession shall:

as soon as possible after the commencement of the case, give notice of the case to every entity known to be holding money or property subject to withdrawal or order of the debtor, including every bank, savings or building and loan association, public utility company, and landlord with whom the debtor has a deposit, and to every insurance company which has issued a policy having a cash surrender value payable to the debtor, except that notice need not be given to any entity who has knowledge or has previously been notified of the case.ⁿ¹²

It also is advisable to provide prompt notice of the chapter 11 filing to all persons having unsatisfied judgments against the debtor and to the debtor's secured creditors.ⁿ¹³

The debtor and its counsel should also be prepared, immediately after the bankruptcy filing, to advise those individuals and entities who have lawsuits pending against the debtor that the lawsuits have been stayed pursuant to *section 362 of the Bankruptcy Code*.ⁿ¹⁴ The courts in which actions against the debtor are pending should also be advised of the bankruptcy filing and the automatic stay.

FOOTNOTES:

(n1)Footnote 1. *See P 9.09 supra* for a discussion of prefiling consultation with the clerk's office and the office of the United States trustee.

(n2)Footnote 2. *See, e.g.,* New York Stock Exchange Listed Company Manual P 204.16; American Stock Exchange Company Guide §§ 401(a) and 402.

(n3)Footnote 3. *See* New York Stock Exchange Listed Company Manual PP 202.06(B) and 202.07; American Stock Exchange Company Guide § 402(b).

(n4)Footnote 4. *See* Soltis, *Public Relations: Luxury or Necessity? PR Counsel Added to Roster of Professionals in Many Chapter 11's*, 4 *Turnarounds & Workouts*, No. 3, at 1 (1990).

(n5)Footnote 5. *See id.* at 2 .

(n6)Footnote 6. *Id.*

(n7)Footnote 7. *Id.*

(n8)Footnote 8. *See, e.g.,* New York Stock Exchange Listed Company Manual PP 202.05 and 202.06; American Stock Exchange Company Guide §§ 402(b)(ii), 403.

(n9)Footnote 9. *See* I. Sulmeyer, D. Lynn & M. Rochelle, *Collier Handbook for Trustees and Debtors in Possession*, P 24.03[1] (Matthew Bender).

(n10)Footnote 10. *See* 17 C.F.R. §§ 240.13a-11, 240.15d-11; Form 8-K, Item 1.03, in *Fed. Sec. L. Rep. (CCH) PP 31,001*.

(n11)Footnote 11. *See P 9.10[2][b] supra*.

(n12)Footnote 12. *Fed. R. Bankr. P. 2015(a)(4)*.

(n13)Footnote 13. *See Collier Handbook for Trustees and Debtors in Possession*, n.9 *supra* , P 24.18.

(n14)Footnote 14. 11 U.S.C. § 362; *see Collier Handbook for Trustees and Debtors in Possession*, n.9 *supra* , P 24.18. Notice of the filing also should be given to counsel for the debtor in any legal proceedings involving the debtor pending at the time of the bankruptcy filing so that no further work is done by such counsel on the debtor's behalf. *See*

id.



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P 9.11 Security Concerns.

The debtor should consider the need to secure its property and premises to avoid any vandalism or theft that might occur as a result of the bankruptcy filing. For example, the debtor should assess the need to employ special security personnel and implement procedures to prevent disgruntled employees from pilfering or destroying facilities or records, particularly facilities and records that are vital to the operation of the business (*e.g.*, computer facilities). Additionally, if the debtor will close business locations upon its bankruptcy filing, security may be necessary to prevent vandalism at those locations.



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P 9.12 Banking.

Before the bankruptcy filing, counsel must advise the debtor of the constraints that chapter 11 imposes on a debtor in possession's banking practices. Advance planning can facilitate the debtor's immediate access to cash in its prepetition accounts and ensure that the funds of the estate are invested in compliance with the Bankruptcy Code's requirements.

[1] Movement of Funds Prepetition.

A chapter 11 debtor will generally have access to funds in any of its prepetition deposit accounts maintained with banks that do not have setoff rights against the debtor. To the extent that a debtor has funds on deposit with a creditor bank that has setoff rights, the debtor may need to take action prior to the filing to ensure that it will have access to the funds postpetition.

If the potential exists for the creditor bank to set off against the debtor's account,ⁿ¹ the debtor may wish to move the funds out of the creditor bank prior to the filing. However, such an action may not be practical. A risk exists that a dramatic shift in banking practices may prompt the creditor bank to take action (including the setoff of funds on deposit) in anticipation of a bankruptcy filing by the debtor. Also, disclosure of the debtor's imminent filing plans may destabilize the debtor's situation. Further, loan agreements between the debtor and the bank may prohibit movement of the funds. Perhaps most significantly, a relocation of funds may be impractical if the debtor utilizes a complicated cash management system.

If it is impractical to relocate the funds prior to the filing, the debtor might seek the bank's agreement that it will not set off against the funds on deposit.ⁿ² The debtor might also seek an agreement relating to the use of cash collateral during the bankruptcy case.ⁿ³

[2] Postpetition Banking.

Upon the filing of a chapter 11 petition, the funds in the debtor's bank accounts become the property of the estate.ⁿ⁴ The prepetition entity no longer has an interest in the assets and they cannot be held in its name. Unless the debtor obtains an order authorizing the use of its old bank accounts, it must be prepared to open new "debtor in possession" accounts immediately after the filing.

[a] Qualified Banking Institutions.

Section 345 of the Bankruptcy Code permits the debtor to deposit or invest the money of the estate in a manner that "will yield the maximum reasonable net return on such money, taking into account the safety of such deposit or investment."⁵ More specifically, to the extent the deposit is not "insured or guaranteed by the United States or by a department, agency, or instrumentality of the United States or backed by the full faith and credit of the United States," the debtor must, "unless the court for cause orders otherwise,"⁶ require the entity with which such money is deposited or invested to post a bond or deposit securities sufficient to insure the deposited funds.⁷

[b] Opening Bank Accounts.

Most chapter 11 debtors will open new "debtor in possession" accounts in qualified institutions immediately after the bankruptcy filing. However, certain debtors may wish to continue using payroll and other accounts maintained prior to the filing date.⁸ This course of action may be most appropriate for a large corporate debtor that has operated through numerous bank accounts and for whom the opening of new accounts would be extremely burdensome.

Bankruptcy courts frequently approve the debtor's use of pre-existing bank accounts, usually after the addition of the words "debtor in possession" to the name on the accounts, checks and forms.⁹ If the debtor wishes to use its pre-existing accounts, counsel should prepare an appropriate motion, pursuant to *section 105(a) of the Bankruptcy Code*,¹⁰ to be filed on the first day of the bankruptcy case.¹¹

The debtor should consult with the United States trustee in advance of the filing to ensure that any bank being considered will satisfy the Code's requirements and gain the necessary approval of the United States trustee.¹²

[3] Notice to Banks.

As noted above, promptly after filing the petition, the debtor in possession must give notice of the filing to all banks and savings and loan associations which hold money or property subject to withdrawal by the debtor.¹³ If the debtor delays in giving notice of the bankruptcy case and the bank does not have actual knowledge of the filing, the bank may transfer the debtor's property to a third party, such as by honoring prepetition checks, and the debtor risks being unable to recover this property.¹⁴

FOOTNOTES:

(n1)Footnote 1. In certain circumstances, state law will provide the creditor bank with a right of setoff. Additionally, the relevant deposit agreement or loan agreement may provide the bank with contractual setoff rights. The Bankruptcy Code recognizes a bank's right to set off deposited funds against the debts owed to the bank by depositors in certain circumstances. *See 11 U.S.C. § 553*. While the filing of the chapter 11 petition automatically stays the bank's right of setoff even if the bank has no notice of the filing, *11 U.S.C. §§ 362(a)(7) and 542(c)*, it does not defeat that right--"setoff is merely stayed pending an "orderly examination of the debtor's and creditor's rights." " 5 *Collier on Bankruptcy*, P 553.06[1] (Matthew Bender 15th Edition Revised) (citing H.R. Rep. No. 595, 95th Cong., 1st Sess. 340-42 (1977), reprinted in Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Edition Revised)). The bank may, however, protect its setoff rights by "freezing" the debtor's account while seeking relief from the automatic stay. *Citizens Bank of Md. v. Strumpf*, 516 U.S. 16, 116 S. Ct. 286, 133 L. Ed. 2d 258, 33 C.B.C.2d 869 (1995) (bank did not violate the automatic stay by placing a temporary administrative hold on the debtor's account while seeking relief from the stay).

(n2)Footnote 2. To the extent that the funds remain in a creditor bank, the debtor must obtain either the creditor's agreement to the use of such funds during the bankruptcy case or court authorization for such use. *See P 9.08[6][a] supra*.

(n3)Footnote 3. *See P 9.08[6][a] supra* for a discussion of cash collateral agreements.

(n4)Footnote 4. *See 11 U.S.C. § 541(a)*. Upon the filing, the accounts are frozen and checks previously written on the accounts will not be honored by the banks.

(n5)Footnote 5. *11 U.S.C. § 345(a)*.

(n6)Footnote 6. Prior to the passage of the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Edition Revised) (the "1994 Act"), all investments were required to be FDIC insured, collateralized or bonded. *See* 140 Cong. Rec. H10767 (daily ed. October 4, 1994, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Edition Revised). The 1994 Act amended *section 345 of the Bankruptcy Code* to allow the courts, "for cause," to approve investments other than those previously allowed. The rationale underlying the amendment was that, while the insurance and bonding requirements of section 345 were "wise in the case of a smaller debtor with limited funds that cannot afford a risky investment to be lost, it can work to needlessly handcuff larger, more sophisticated debtors." 140 Cong. Rec. H10767 (daily ed. October 4, 1994, *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Edition Revised).

(n7)Footnote 7. If, because of the size of the deposit, the debtor encounters difficulty in finding a bank that will satisfy the requirements of section 345, the debtor might consider distributing its funds among several banks within the district or investing its funds in government securities. *See* A. Resnick, *Bankruptcy Practice and Strategy*, 1991 Supp., P 12.02[3] (WGL 1987 & Supp. 1991).

(n8)Footnote 8. Special accounts are not subject to a bank's right of setoff. *See United States v. Butterworth-Judson Corp.*, 267 U.S. 387, 45 S. Ct. 338, 69 L. Ed. 672 (1925). Such special accounts might include payroll accounts. *See Akerman v. N. Fork Bancorp. (In re Jat Management of Ohio)* 2002 Bankr. LEXIS 1546, 51 (Bankr. D. Conn. 2002) (special accounts are not subject to a bank's right of setoff because funds in special accounts remain the property of the depositor).

(n9)Footnote 9. [Reserved]

(n10)Footnote 10. *11 U.S.C. § 105(a)*.

(n11)Footnote 11. The banking institutions must, of course, meet the requirements of *section 345 of the Bankruptcy Code*. *See* P 9.12[2][a] *supra* for a discussion of section 345.

(n12)Footnote 12. The office of the United States trustee in the relevant jurisdiction may provide a list of authorized bank depositories. The office of the United States trustee may also provide a form for the application of the depository institution for approval of the required bond.

(n13)Footnote 13. *Fed. R. Bankr. P. 2015(a)(4)*. *See* P 9.10[2][d] *supra* for a discussion of *Fed. R. Bankr. P. 2015(a)(4)*.

(n14)Footnote 14. *See 11 U.S.C. § 542(c)*.



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P 9.13 Books and Records.

The debtor will need to conform its accounting and bookkeeping procedures to the requirements of the Bankruptcy Code and Rules. Most importantly, the debtor will need to close its account books and open new books on the first day of the chapter 11 case. Such a procedure facilitates the differentiation between pre-and postpetition obligations of the debtor. Additionally, during the course of the chapter 11 case, the debtor will be subject to financial record-keeping and reporting requirements.ⁿ¹ Any accounting or bookkeeping adjustments necessary to allow the debtor to satisfy its reporting obligations should be made in advance of the filing.ⁿ²

FOOTNOTES:

(n1)Footnote 1. The Federal Rules of Bankruptcy Procedure impose certain obligations on the debtor. *See, e.g., Fed. R. Bankr. P. 2015(a)(2)* (requiring the debtor to keep a record of receipts and the disposition of money and property received); *Fed. R. Bankr. P. 2015(a)(5)* (requiring debtor to file and transmit to the United States trustee quarterly statements of disbursements and statements of the amount of the fee required pursuant to *28 U.S.C. § 1930(a)(6)* that was paid for the relevant quarter). Local bankruptcy rules and United States trustee issued guidelines will likely impose additional record-keeping and reporting requirements.

(n2)Footnote 2. To the extent that the debtor's books and records are incomplete or inaccurate, the debtor may need to retain the professional services of accountants or bookkeepers.



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P 9.14 Utilities.

Another consideration in the prefiling period concerns the continuation of the debtor's utility service after the filing. If the debtor's business will continue in operation postpetition, it is essential that the debtor's utility service not be interrupted. *Section 366(a) of the Bankruptcy Code* prohibits a utility from altering, refusing or discontinuing service to, or discriminating against the debtor solely on the basis of the commencement of the bankruptcy case or the fact that a debt owed by the debtor to the utility for service rendered prior to the filing was not paid when due.ⁿ¹ However, section 366(b) imposes an important limitation on that prohibition, requiring the debtor, within 20 days after the date of the filing, to furnish "adequate assurance of payment, in the form of a deposit or other security, for service after such date."ⁿ²

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 significantly enhances leverage of utilities. In a chapter 11 case, pursuant to section 366(c), a utility may alter, refuse, or discontinue service to the debtor if during the first 30 days after filing the bankruptcy petition, the debtor does not provide adequate assurance of payment that is satisfactory to the utility.ⁿ³ For purposes of section 366(c), the term "assurance of payment" means a cash deposit, a letter of credit, a certificate of deposit, a surety bond, a prepayment of utility consumption, or any other form of security that is mutually agreed on between the debtor and the utility.ⁿ⁴ However, an administrative expense priority claim is not considered a form of adequate assurance.ⁿ⁵ The debtor may seek modification of the amount of assurance; however, the court cannot consider the debtor's history of timely prepetition payments, or the availability of an administrative expense priority.ⁿ⁶

Accordingly, in most cases, the debtor must be able, within a short time after the commencement of the case, to provide adequate assurance of payment. Because a debtor that gives advance notice of its imminent filing to utility companies runs the risk that the utility companies will discontinue service before the filing, pre-filing negotiations should not be conducted absent unusual circumstances. Nonetheless, in the prefiling period, the debtor can and should formulate a plan for meeting the requirements of section 366 immediately after the filing. Such planning should include an analysis of the debtor's postpetition utility needs, identification of those utility companies that will be needed to provide services, and determination of whether any such utility companies maintain deposits from the debtor.

A debtor that will have to provide adequate assurance of payment to numerous utilities may find it extremely burdensome, if not impossible, to negotiate adequate assurance with each utility in the limited period provided by the Code. Therefore, the debtor may attempt, through a first day motion, to obtain an extension of the period during which

the utilities cannot discontinue service.

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 366(a)*.

(n2)Footnote 2. *11 U.S.C. § 366(b)*.

(n3)Footnote 3. *11 U.S.C. § 366(c)(2)* (effective for cases filed on or after October 17, 2005).

(n4)Footnote 4. *11 U.S.C. § 366(c)(1)(A)*.

(n5)Footnote 5. *11 U.S.C. § 366(c)(1)(B)*. This new requirement in section 366(c)(1)(B), effective for cases filed on or after October 17, 2005, is a departure from prior law.

(n6)Footnote 6. *11 U.S.C. § 366(c)(3)*.



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P 9.15 Insurance.

The debtor should ensure that its property and casualty insurance coverage is kept in effect through the filing of the chapter 11 petition. Additionally, in the prefiling period, the debtor should consider its position with respect to director and officer insurance. Even in the unlikely event that the debtor could persuade an insurer to provide or renew director and officer insurance coverage during the chapter 11 case, it may be difficult for the debtor to obtain creditor and court approval for the expenditure of the estate's funds for such insurance. Accordingly, the debtor should renew any existing director and officer insurance policies or attempt to obtain director and officer coverage (or its equivalent) prior to the filing.ⁿ¹

FOOTNOTES:

(n1)Footnote 1. *See P 3.05[6] supra*, for a discussion of director and officer insurance.



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1-9 Collier Business Workout Guide P 9.16

P 9.16 Taxes.

Prior to the bankruptcy filing, counsel for the debtor should ensure that the debtor has met those prepetition tax obligations for which the debtor's officers could be held personally liable. The debtor's failure to pay any prepetition withheld income and employment taxes or collected excise taxes may result in the debtor's officers being held personally liable for the full amount of the tax.ⁿ¹ The automatic stay provision of the Bankruptcy Code does not protect the debtor's officers from personal liability for the unpaid taxes.

FOOTNOTES:

(n1)Footnote 1. The Internal Revenue Code provides:

"Any person required to collect, truthfully account for, and pay over any tax imposed by [the Internal Revenue Code] who willfully fails to collect such tax, or truthfully account for and pay over such tax, or willfully attempts in any manner to evade or defeat any such tax or the payment thereof, shall, in addition to other penalties provided by law, be liable to a penalty equal to the total amount of the tax evaded, or not collected, or not accounted for and paid over." *I.R.C. § 6672, 26 U.S.C. § 6672*. The term "person" "includes an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs." *I.R.C. § 6671, 26 U.S.C. § 6671*.