Observations Regarding Chapter 11 Practice in United States
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I. Introduction

The United States Bankruptcy Code is an integrated insolvency statute that is divided into separate chapters, each of which deals with specific bankruptcy related issues. In order to create the integrated system, and to avoid unnecessary duplication, the Code has certain chapters that are generally applicable to all types of proceedings and certain other chapters that are only applicable in specific types of cases. Thus, the first three chapters (1, 3 and 5) contain legal rules and principles that are applicable to each of the subsequent chapters that deal with specific types of proceedings. These are: Chapter 7 (liquidation); Chapter 9 (insolvency of municipalities and other political subdivisions of states); Chapter 11 (reorganization); Chapter 12 (reorganizations of family farms); and Chapter 13 (reorganization of natural persons who are wage earners).[1]

Therefore, a discussion of court-supervised corporate reorganization and rehabilitation under US law necessarily involves a discussion of the relevant provisions not only of Chapter 11 but also of Chapters 1, 3 and 5.

II. Whether to Reorganize or to Liquidate?

[1] Chapter 15 incorporates the UNCITRAL Model Law on Cross-Border Insolvency into the US Bankruptcy Code.

A voluntary petition by the debtor almost always commences a reorganization case in the US.[2] Unlike most continental laws, the proceeding is opened and becomes effective immediately upon filing of the petition, without the need for court order or intervention.[3] The term used to connote the opening of a proceeding is "entry of an order for relief." Although the statute uses the word "order," the judge never enters an actual order. Rather, the order is deemed to have been entered automatically upon the filing of the petition.[4] The most important, and immediate, effect of the entry of an order for relief is the imposition of the "automatic stay," a broad moratorium on virtually all collection related activity by creditors.[5]

The choice of whether to reorganize or liquidate lies initially with the debtor; however, any party in interest (normally a creditor) may ask the court to convert a Chapter 11 case to one under Chapter 7.[6]

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[2] Section 301(a). The one primary exception is when creditors commence an involuntary Chapter 7 case under Section 303 (a relatively rare occurrence) and the debtor consents to the opening of the case on the condition that it be converted from Chapter 7 to Chapter 11, thereby allowing the debtor to remain in possession and seek to reorganize.

[3] Section 301(b).

[4] As all papers filed in the US Bankruptcy courts are recorded and indexed electronically, the exact date and time of the filing is automatically generated and noted on the court record. The automatic stay is effective against all entities, whether or not they have notice of the filing, from and after the precise moment of the "entry of the order for relief."

[5] Section 362(a). There are some specific, and limited, exceptions to the scope of the automatic stay. See Section 362(b).

[6] The Code sets forth specific standards for conversion, including continuing operational losses, gross mismanagement, failure to meet statutory deadlines, among others. Section 1112.

The primary issue confronted in every reorganization case is whether the enterprise can generate more value for its creditors through reorganization than through liquidation. While at first blush it may appear obvious that reorganization always would generate more value, that conclusion is far from true. For example, the enterprise may be losing money through loss of markets, excessive expenses, poor management, quickly depreciating assets, among other factors. In such a case, there may be negative “reorganization value” in the enterprise and creditors would be best served through a quick sale of assets. Under the US Code, such a sale can occur either through a Chapter 7 proceeding overseen by a trustee or through the Chapter 11 process, even though this would not seem to be ”reorganization” in the eyes of some observers.

The reorganization versus liquidation question arises in many contexts in a Chapter 11 case. A non-exclusive list of such contexts includes:

1. Whether the plan will generate more return to creditors than liquidation -- a key question that the court must address in every Chapter 11;
2. Whether a case should be converted to one under Chapter 7;
3. Whether the court should approve a reorganization plan; ;
4. Whether the benefit to an enterprise of obtaining post-petition financing during the proceedings outweighs the burden of the additional debt; and

5. Whether a quick sale should be approved rather than allowing time for a reorganization plan to be proposed and considered.[7]

To address these questions, the court usually has to compare the results of liquidation under a "hypothetical" Chapter 7 with the likely result of a proposed, or even not yet formulated, plan of reorganization. This is an uncertain exercise at best but one where the court will usually receive the benefit of expert opinion provided by the opposing parties.[8]

III. How are issues resolved under US practice?

The US legal tradition embraces an adversary system of finding the truth. The judge's role is to resolve disputes, determine disputed facts and exercise his or her discretion and judgment in deciding whether statutory standards have or have not been met. The judge must rely upon facts that are admissible in evidence under our Federal Rules of Evidence and may not consider evidence that is inadmissible or information learned outside of the litigation process. The judge is not an advocate for either side and, generally speaking, relies only upon information and expert opinion presented by the parties in open court. In complex insolvency cases, the judge may appoint an "examiner" to review and report on certain critical

[7] In the usual scenario, the secured creditor(s) advocate for a quick sale to avoid deterioration of their collateral while the unsecured creditors advocate for time for a plan, given that repayment of their debt will only be possible from future revenues in a reorganized enterprise.

[8] Although the Rule 706 of the Federal Rules of Evidence permits the Court to appoint an independent expert to provide opinion or advice on specified matters, this procedure is rarely used in practice. The norm is for the parties each to hire their own experts and for the Court to hear the evidence and determine which opinion is more credible.

factors in the case, such as the causes of the insolvency, unwinding complex transactions, reviewing financial records, understanding insider transactions and similar issues.[9] While the court enters the order to appoint an examiner, the judge himself or herself does not choose the examiner. That role is left to the United States Trustee, an agency of the Department of Justice, whose mission is to promote the integrity and efficiency of the bankruptcy system for the benefit of all stakeholders – debtors, creditors and the public. The US Trustee is required by statute to consult with the affected parties in making the selection and the court is required to approve the appointment, but the primary obligation lies with the Trustee.

Although some hotly contested issues are eventually decided by the judge, the most common resolution of most disputes is through negotiated settlements. Particularly in bankruptcy cases, where the costs of litigation can be excessive and resources are limited, negotiated settlements are an accepted method for the parties to resolve contested issues by balancing the benefit of a favorable outcome against the possibility of an unfavorable outcome, including the costs of litigation. Where such a settlement affects the rights of many parties, the court must approve the agreement. Although the standards vary slightly depending on the venue of the case, the general rule is that the court will not substitute its judgment for that of

[9] An examiner is an officer of the court who must be impartial and must disclose all relationships with parties to the case and must disclose his or her proposed compensation. The compensation of the examiner is subject to approval of the Court after notice to all parties. Sections 1104, 330 and Federal Rule of Bankruptcy Procedure 2016.

the settling parties, but rather will consider whether the proposed resolution adequately balances the likelihood of a favorable or unfavorable result and the expenses avoided by terminating the litigation. If the court determines that the proposed resolution is within the "zone of reasonableness," it will approve the agreement, even if the judge would have preferred a different result.[10]

IV. The Automatic Stay

The automatic stay is one of the most important and powerful provisions in the Bankruptcy Code. It a broad injunction prohibiting a wide range of creditor action, including commencing or continuing litigation against the debtor, seeking to collect a judgment, repossessing or foreclosing on collateral, granting or registering a security interest in collateral and set off of mutual debts. Several of its key components include:

1. It goes into force immediately at the time the filing of petition, whether voluntary or involuntary, without any action required by a judge;

2. It is applicable against "all entities," including secured creditors and government creditors, such as taxing agencies;

3. It is effective against a creditor EVEN IF that creditor has no notice of the bankruptcy filing. Generally, if a party takes an action that is within the scope of the stay after the stay arise, that action is void and will be treated as if it

[10] This procedure is authorized by Federal Rule of Bankruptcy Procedure 9019. That rule requires that an adequate explanation of the settlement and notice of the hearing set to consider it must be given to all affected parties and that such parties have the opportunity to object.

did not occur.[11] For example, if a foreclosure sale takes place in violation of the stay, that sale will be set aside and the mortgage or other encumbrance reinstated; and

4. It is NOT effective against, and does not enjoin, criminal proceedings involving the debtor, certain family law proceedings, administrative tax proceedings (audits, assessments, etc.),[12] certain financial transactions involving complex derivatives and similar securities[13] and actions by the government under its police and regulatory powers.[14]

Because of the breadth and strength of the automatic stay, the Code also contains provisions empowering parties subject to the stay to ask the Court on an expedited basis to provide relief from the stay. The statute authorizes four kinds of relief: 1) modification of the stay; 2) termination of the stay; 3) conditioning the stay; and 4) annulling the stay. Thus, the court has wide discretion to fashion a remedy that is appropriate to the circumstances.[15] As a general rule, there are two issues the court may address in deciding whether to give relief from the stay: 1)

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[11] In some federal circuits, the actions are considered "voidable", not "void." The statute itself does not specifically address this question is subject to varying judicial interpretations.

[12] However, the actual *collection* of taxes is subject to the stay.

[13] These securities include repurchase agreements, master netting agreements, interest rate swaps and forward contracts, among others.

[14] This is a partial list of exemptions to the stay.

[15] These are examples of the four types of relief: 1) modification: providing that the stay will terminate in the future after a set period of time; 2) termination: providing that the stay will terminate immediately; 3) conditioning: providing that the stay will remain in place so long as the debtor pays a determined amount of money to the creditor for a determined period of time; and 4) annulling: providing that the stay will be deemed to have been terminated at a point PRIOR to an act taken in violation (for example, a foreclosure) so that the act is validated and not deemed void.

are the interests of the creditor adequately protected[16]; or 2) in a reorganization case, is there equity[17] in the collateral and is the collateral necessary for an effective reorganization[18]?

"Adequate protection" is a term of art in bankruptcy that encompasses the concept that a creditor's position should not be diminished because the stay precludes it from exercising its rights. Thus, if the value of collateral is diminishing after the case is filed, the stay should be removed unless the debtor makes up the deficit, either by additional collateral, periodic payments or some other equivalent value.

The other basis for relief from the stay also requires a determination of value; however, this test is simply whether the value of the property is less than the amount of the debt rather than whether the value of the property will decrease over time. However, even if the court finds a lack of equity, that is not the end of the inquiry. The court must also determine that the property in question is not necessary to an effective reorganization.[22] A simple example will illustrate this principle. A shoe manufacturer may have equipment for making its shoes that is encumbered by secured debt in an amount in excess of the value of the equipment. Therefore, there is no equity in the property. But if the shoe manufacturer is able

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16 Section 362(c)(1).
17 In this context, "equity" means value in excess of the amount of the debt.
18 Section 362(c)(2).
22 The US Supreme Court has explained this term to mean that the property is essential to an effective reorganization that is in prospect, and that there is a reasonable possibility to confirm such a plan within a reasonable period of time.

to propose a plan of reorganization that involves the continued production of shoes using this equipment, and it is reasonably possible that such a plan may be confirmed within a reasonable period of time, the court will deny the request for relief from the stay. However, if the equipment is also declining in value, as is normal for equipment used in manufacturing, the debtor must still provide "adequate protection" to the creditor or the stay will be removed and the property lost to foreclosure. This will normally be in the form of post-petition payments to the creditor.

V. Collection of Assets

Most Chapter 11 cases will require the routine collection of accounts receivable, resolution of disputes arising out of breach of contract, sale of excess or outdated property and similar actions to reduce illiquid assets to money for funding of the cost of administration of the proceeding or payments to creditors. Usually, however, the more important litigation cases are avoidance or claw-back cases brought against third parties. The most common avoidance actions are for the return of preferential payments or transfers and for setting aside or revoking fraudulent conveyances.[23]

A preference is any pre-petition transfer of property of the debtor to a creditor that results in that creditor receiving a greater percentage of its claim than

[23] These types of proceedings are common to many insolvency laws. However, in some systems, they are restricted to liquidation proceedings and not allowed in reorganization cases. Under US practice, the "debtor-in-possession", or DIP, has the same rights and powers of a trustee to pursue such cases.

it would have received in a Chapter 7 liquidation proceeding. The simple idea is to protect the interests of creditors who have NOT been paid by requiring those who HAVE BEEN paid to repay the amount received that distorts equality of treatment among similarly situated creditors. But, for such a transfer to be avoidable, other conditions must be met. First, the transfer must have been made within the statutory "suspect period" prior to the filing of the case. For most preferences, this period is ninety days; for transfers to "insiders,"[25] the period is extended to one year. Second, the transfer must have been made while the debtor was insolvent.[26] This makes sense because the pre-payment would not be prejudicial to other creditors similarly situated if the debtor's property was of a sufficient value to pay all creditors in any event.

There are two common situations. The first is the payment to one creditor to the exclusion of other creditors similarly situated. Thus, if one supplier is paid, and another is not, the DIP may recover the payment from the first in order to equalize the position of the two creditors. The transferee receives an unsecured claim for the amount returned. The transferee may raise as a defense the fact that the transfer was made in the ordinary course of business or that it extended new credit after the transfer was made.

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[25] Insiders include family members, members of an enterprise's control group, owners of an enterprise and enterprises of which the debtor is an owner or member of the control group, among others. Section 101(31).

[26] The debtor is presumed to be insolvent for the ninety day period immediately prior to the commencement of the case; a party opposing the preference action may overcome this presumption by presenting contrary evidence.

Because of the intensely factual nature of these cases, they are usually settled with the transferee paying a lower amount in compromise.[27]

The second common preference occurs when a previously unsecured creditor is given an interest in collateral within 90 days of the filing. If this secured transaction were to stand, the creditor would be preferred over other similar creditors that did not receive collateral. The common remedy is to set aside the security interest.[28]

There are two types of fraudulent conveyances. The first is subjective in nature. If a debtor makes a transfer prior to the filing with the intent to hinder, delay or defraud its creditors, the transferred property, or its money equivalent, may be recovered. This requires proof of an actual intent. The Code provides a "look back" period of 2 years; in addition, the DIP may stand in the shoes of a creditor who could have brought a claim under applicable state law. Under many state laws, the "look back" period is at least four years. These cases are relatively rare because of the difficulty of proving the requisite "intent to defraud."

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[27] In addition, it is important to remember that, after repaying the preference amount, the creditor will have an unsecured claim in the amount of what was repaid and is entitled to the same percentage payment on that claim as any other unsecured creditor.

[28] After the security interest is set aside or invalidated, the value of the property to which the security interest previously attached is preserved for the benefit of the estate, primarily the unsecured creditors. For example, if there is another secured creditor on the same property whose lien is junior the one set aside, that secured creditor will remain in the same priority and will continue to be junior to the value that has been preserved for the benefit of the bankruptcy estate.

The second type is objective in nature. If a debtor transfers property while insolvent and does not receive "reasonably equivalent value" in return, the DIP may avoid the transfer for the benefit of the estate, regardless of whether the debtor subjectively intended to hinder, delay or defraud its creditors. As above, the look back period may range from two to four years. This type of case is much more common because it does not require evidence of "intent to defraud" and may be proven primarily with records of the transfers and evidence of valuation.

It is not unusual for avoidance actions to constitute a major portion of the unencumbered assets of the estate.[29] In some large Chapter 11 cases, there may be hundreds or even thousands of such cases filed. There are efficient and effective ways to resolve such a large volume of cases. First, one or a small group of cases may be prepared for trial to establish certain facts that may be common to many cases; such facts could include insolvency and what constitutes the "ordinary course of business." The decisions by the Court on these issues can create a framework for resolving, through settlement or litigation, other cases with similar facts. Second, a single mediator can be chosen to develop a framework for resolving the cases, thereby expediting settlement of all of them.

[29] "Unencumbered assets" are not subject to a mortgage or security interest in favor of a particular creditor and therefore are often a primary source of funds to repay unsecured creditors.

VI. Sales of property not in the ordinary course of business

Reorganization has always been a flexible concept in US bankruptcy law. The Code provides certain required contents for any plan, but those requirements are broadly, not prescriptively, written.[30] One of the options presented is for the sale of substantially all of the assets of the debtor to a third party, typically as a going concern. This is similar to the so-called "hive-down" under UK practice where "good assets" (but not the liabilities) are transferred to a new wholly owned subsidiary and the bad assets are left behind with the liabilities at the parent level. The payment to the parent can be in cash or in shares of the subsidiary; the shares of the subsidiary can now be sold to a third party that will receive an operating business with a clean balance sheet. The parent can then be liquidated with the proceeds of the sale, plus any value from the "bad assets", used to pay creditors.

Chapter 11 does not require, but does allow, a similar transfer to achieve a similar result. Because a sale of a significant portion of the business is specifically provided for in Chapter 11, there was considerable controversy in prior years whether a sale of this type could take place *without a plan of reorganization*. That controversy has been largely resolved and, under current practice, cases often include quick sales of major operating portions

[30] Section 1123.

of debtor enterprises[31].

Issues that must be addressed by the Court include: whether the sale is necessary to protect the rights of all creditors (and not just the rights of the secured creditors); whether the assets have been adequately marketed and the price to be paid fairly represents their value; whether adequate notice of the sale has been given to all creditors and other parties in interest; whether the proposed sale provides a fair opportunity for other buyers to offer a higher and better price; whether there are provisions in the sale documents that may "chill the bidding" such as payments to be made to the original buyer if outbid by a new buyer,[32] or restrictions on the ability to market the assets to other after the sale agreement is signed.[33]

VII. Financing the Chapter 11 Business

In the US, we often say: "Cash is King." Nowhere is this saying truer than in a Chapter 11 case. The process has become enormously expensive; professional fees for lawyers, investment bankers, financial advisors, appraisers and accountants can easily add up to many millions of dollars in large cases.[34] In addition to these extraordinary expenses, there are the usual expenses associated with operating the business: employ salaries, rent,

[31] Sales are governed by Section 363.
[32] This is known as a "break up fee."
[33] This is known as a "lock up" provision.
[34] Lehman Bros. is the largest case ever filed in the US Bankruptcy Court. Approved professional fees now exceed $2 billion.

inventory, research and development, utilities, manufacturing costs, equipment purchasing or leasing—and the list goes on. Therefore, finding a means for financing a Chapter 11 is of paramount importance.

There are three broad sources of financing. The first is to use unencumbered assets; that is, assets that are not subject to a security interest or mortgage. If the debtor has unencumbered cash, that is the best and easiest source of liquidity. However, for obvious reasons, it is highly unusual for a Chapter 11 debtor to have sufficient unencumbered cash to pay for its ongoing needs. In addition, any moveable or immoveable property that is not required for the operation of the business may be sold to provide needed cash. Again, the economic reality is that it is unlikely that such property will exist in adequate amounts.

The second is to use cash that is the product of assets that are encumbered. In a typical revolving financing arrangement, the Debtor's secured lender will have a lien on inventory and the accounts receivable that result from the sale of the inventory. Under US collateral law, the security interest extends to the proceeds of the sale of collateral; thus, the cash that results from the sale of the inventory and/or the collection of the accounts receivable also are subject to the lien of the lender. The Code has two important provisions that affect the use of this cash. First, a "floating charge"

does NOT attach to property acquired AFTER the filing of the case,[35] but the charge continues on any identifiable proceeds of collateral to the extent they are within the scope of the pre-petition security agreement.[36] Second, a debtor may NOT use such "cash collateral" without either the consent of the creditor or a court order based on a determination that the interests of the creditor will be adequately protected notwithstanding the use of the cash collateral.[37] Typically, the conditions for the use of cash collateral are negotiated between the parties; commonly, the creditor will approve the use of such cash only for purposes that directly benefit the operations of the business and, consequently, protect the value of the underlying collateral and in exchange for a lien on post-petition assets that would normally be exempt from the lien.

The third source is "DIP financing." This is the term used to describe new loans made to the debtor after the case has been filed.[38] The Code authorizes such loans only with the approval of the court.[39] The debtor must demonstrate that it has attempted, and failed, to obtain debt on terms less onerous than those for which it seeks approval. It may obtain credit on either a secured or unsecured basis, although secured debt is far more common.

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[35] Section 552(a)
[36] Section 552(b).
[37] Section 363(c)(2).
[38] DIP, or post-petition, financing is governed by Section 364.
[39] The debtor may incur unsecured debt in the ordinary course of business without the express approval of the court. This includes such common types of credit as open account trade debt, employee salaries and the like.

Although the Code authorizes the debtor to obtain credit secured by liens SENIOR to existing liens[40], the requirements are very difficult to prove.[41] As a result, the most common source for such financing is a prepetition secured lender. This lender may determine that allowing the debtor to continue to operate is the best way to maintain the value of its collateral and to enhance the likelihood of repayment. Therefore, it may consent to a senior lien, in favor of itself, to provide the necessary financing. Although the DIP loan itself will be therefore well-secured, the addition of new debt senior to the existing debt will increase the lender's exposure. As a result, the negotiations for such loans are usually very difficult. This type of financing can only be made after the court has approved the terms after notice of the proposed financing to all creditors and parties in interest. If the proposed lending contains terms that the court finds are too onerous or overly favorable to the DIP lender, it may reject the request.[42] Although the debtor may agree to certain aggressive terms, the court's order will typically give creditors, in particular the Official Committee of Unsecured Creditors, additional time to bring challenges to certain of the loan terms.

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[40] This is a called a "super priority" or "priming" lien.

[41] In effect, the debtor must demonstrate that the existing creditor will not be prejudiced by a senior lien, proof of which may only be possible where there is very substantial equity in the property. Even then, the existing can argue persuasively that a senior lien of any amount damages its property rights.

[42] Typical provisions that are controversial include asking the court to determine that the prepetition liens are valid in all respects, requiring the debtor to waive protection of the automatic stay, asking that previously unsecured prepetition obligations be secured as part of the transaction, and similar requests.

VIII. Executory contracts and unexpired leases

Section 365 of the Code has special rules for executory contracts and unexpired leases. As a general rule, a contract is "executory" if both parties to the contract have obligations remaining to be performed. The DIP may choose either to "assume" or "reject" an executory contract or unexpired lease. If the contract is assumed, the DIP must cure all past defaults and must provide "adequate assurance of future performance." In other words, it must show that it is unlikely to default in the future. The DIP may also assign the estate's rights under the contract to a third party. This may occur, for example, in a circumstance where the contract provides the estate with a long term opportunity to purchase goods on a below market basis; in such case, the assignee (buyer) will pay the estate a premium to receive the benefits of the contract.

If the contract or lease is burdensome or of little value, the DIP may "reject" it and thereby relieve the estate of the obligation to continue to perform. As an example, a DIP may reject a long term lease for a property where it no longer wants or needs to conduct business. Upon rejection, the estate no longer owes rent and the lessor obtains possession, free to sell or re-lease to a new tenant. The remaining rent obligations are treated as an unsecured claim, subject to a statutory cap that is roughly equivalent to between one and three years rent, depending on the length of the remaining

term.

The decision is "reject" is subject to the "business judgment" rule and only rarely may be successfully contested by the counter-party to the agreement. In order to "assume" the contract, the DIP must cure all past defaults and provide "adequate assurance of future performance," in other words, evidence that it likely will be able to perform the contract's obligations in the future. Once a lease is assumed, any damages resulting from a FUTURE default are entitled to administrative expense priority, the highest priority level for claims that are not secured by an interest in property. The DIP may also "assign", or sell, its interest in an executory contract or lease to a third party, notwithstanding a statutory or contractual prohibition against assignment. Such a contact must first be "assumed" (defaults cured) and the assignee, or buyer, must provide "adequate assurance of future performance." The DIP may not assume a contract for financing; in other words, it cannot force a lender to fulfill a pre-petition commitment to lend if the lender declines to do so.

IX. The plan of reorganization

The plan of reorganization is at the heart of the Chapter 11 process. If approved, or "confirmed" in the language of Chapter 11, the plan becomes a new contract between the reorganized debtor and its creditors, enforceable in the same manner as any other contract, subject to specific provisions in the

plan itself.

Key to the process is the classification of claims. The law requires that a plan may "place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class."[43] This provision has been interpreted not only to mean that a claim must be similar to other claims in the class but, in certain situations, that all claims of a similar nature must be placed in the same class. This extension of the statutory language is controversial. The distinction between the two interpretations is subtle but important because voting on the plan is conducted by class and there are certain requirements, explained below, for acceptance of the plan by creditor classes in order for the plan to be confirmed. Classification is also critical because acceptance of a plan by a class binds **all** creditors in that class, whether they voted to reject the plan or did not vote at all.

Each secured creditor is ordinarily placed in its own class. This is because no other creditor has the same rights as it has against its collateral. Thus, the bank secured by the land and building would be in one class, while the bank secured by the equipment and inventory would be in another. Likewise, the creditor with a junior lien on the land and building would be in a different class from the bank with senior lien because, even though they

[43] Section 1122(a)

have liens against the same collateral, their rights are very different because of their respective priorities.

The debtor has the exclusive right to propose a plan for the first 120 days following the filing of the case and the exclusive right to solicit acceptances of its plan, if one is filed, for the first 180 days following the filing of the plan.[44] Prior to 2005, each of these deadlines could be extended indefinitely upon motion of the debtor demonstrating good cause; amendments in 2005 limit the extension of the first deadline to 18 months after the commencement of the case and the second deadline to 20 months.[45] A creditor may seek an order from the court shortening the exclusivity period if it can show good cause. Once exclusivity is terminated, any creditor or party in interest may propose a plan.

The plan must be accompanied by a disclosure statement, the purpose of which is to provide adequate information to a hypothetical investor to make an informed judgment on whether or not to accept the treatment proposed in the plan. The statute does not, with a few exceptions, prescribe what must be in a disclosure statement, leaving that determination to the judge taking into consideration the nature of the case, the availability of financial records, the benefit of additional information to the creditors and

[44] Section 1121(c).
[45] Section 1121(d).

the costs associated with providing more detailed disclosure.[46]

The law requires that the proponent of the plan send to each creditor and party in interest the approved disclosure plan, together with the plan, before either proponents or opponents of the plan may solicit votes accepting or rejecting the plan. In recent cases, the courts have approved dissemination of the disclosure statement through mailing a CD-ROM or providing access to a secure website. Such orders routinely require that papers documents be provided upon request.

The rules require at least 28 days' notice to all creditors and parties in interest of the hearing to approve the disclosure statement.[47] Most judges discourage extensive litigation on the adequacy of the disclosure statement, instead requiring the parties to work together to craft a statement that is acceptable to all.

Since 2005, the law has specifically allowed the court to approve the disclosure statement preliminarily in order to set the date for hearing on confirmation of the plan more quickly, leaving the final approval of the disclosure statement for the same date and time of the confirmation hearing.

The hearing on plan confirmation also requires at least 28 days' notice to all creditors and parties in interest and, except as mentioned above, may not be determined until after the disclosure statement has been approved.

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[46] Section 1125.
[47] Federal Rule of Bankruptcy Procedure 2002(b)

Typically, a date is set by which creditors must vote and must file any legal objections to the confirmation of the plan (*i.e.*, that the plan does not conform to mandatory provisions in the law). This date is normally at least one week prior the initial confirmation hearing and most courts require the proponent of the plan to file a "ballot report" several days prior to the hearing indicating the results of voting by class.

If the plan is consensual, the Court may confirm it at the initial hearing. If there are objections for which further briefing is required or evidence must be taken, or if the plan may be confirmed only over the objection of at least one dissenting class of creditors (see the section on "cram down" below), then the initial hearing will normally be used to establish a final hearing date and all interim deadlines.

Section 1123 sets forth both the required and optional contents of the plan. The most important required contents are:

1. Designation of classes of creditors;
2. Specification of those classes of claims whose rights are not impaired by the plan;
3. Specification of the treatment of those classes whose rights are impaired by the plan;
4. Provision for the same treatment for each member of a class, unless a member of the class agrees to less favorable

treatment;

5. Provision of adequate means for the implementation of the plan; and

6. Provisions for selection of post-confirmation management and corporate governance that are "consistent with the interests of creditors, equity security holders and public policy."

The optional contents of a plan relate primarily to the methods of reorganization to be used to achieve the plan's goals. These methods are very broadly defined and are non-exclusive; in other words, the plan may use methods not specified in the statute if consistent with the overall purposes of the Code and not otherwise prohibited by law. A list of the optional contents includes:

(A) Retention by the debtor of property of the estate;

(B) Transfer of property of the estate to one or more entities;

(C) Merger or consolidation of the debtor with one or more entities;

(D) Sale of property of the estate, either subject to or free of any lien; or the distribution of property of the estate among those having an interest in it;

(E) Satisfaction or modification of any lien;

(F) Cancellation or modification of any indenture or similar instrument;

(G) Curing or waiving of any default;

(H) Extension of a maturity date or a change in an interest rate or other term of pre-petition debts;

(I) Amendment of the debtor's charter;

(J) Issuance of securities for cash, for property, for existing securities, or in exchange for claims or interests;

(K) Impair or leave unimpaired any class;

(L) Provide for the assumption, rejection, or assignment of any executory contract;(M) provide for—

(A) The settlement or adjustment of any claim; or

(B) The retention and enforcement of any claim;

(N) Provide for the sale of all or substantially all of the property of the estate, and the distribution of the proceeds of such sale among holders of claims or interests; and

(O) Include any other appropriate provision not inconsistent with the applicable provisions of this title.

It is important to understand the flexibility and creativity that are inherent in the Chapter 11 process. The idea is to provide the plan proponent with a wide palette of colors from which to create the image of its reorganized debtor.

Voting occurs by mailed written ballot after approval of the disclosure

statement. Electronic voting may be authorized. In larger cases, the plan proponent may contract with a company that specializes in shareholder and creditor voting services to receive, count and verify the ballots. Unlike many European systems, there is no creditors assembly at which voting takes place.

A class of claims accepts a plan if the plan has been accepted by creditors that hold at least two-thirds in amount and more than one-half in number of claims that have actually voted. For example, assume a class of claims contains 100 creditors holding claims in the amount of $10 million. Assume that only 50 creditors holding $6 million in claims actually vote; the other creditors simply do not return a ballot. The class will accept the plan if at least 26 creditors (more than half) holding at least $4 million in claims (at least 2/3 in amount) vote to accept. This affirmative vote by 26% of the creditors holding only 40% of the outstanding debt in the class will be binding upon all 100 creditors holding $10 million in claims. The idea is to reward those who participate and not to give a veto to those who do not.

Plans are routinely modified up to the time of confirmation in order to facilitate the negotiated resolution of objections by creditors. The plan as modified will be the binding contract. The modified plan needs be sent out for further solicitation only if it substantively changes the rights of creditors in other classes. The plan as modified must comply with sections 1122 and 1123 (dealing with classification and the contents of the plan) and meet all of the

confirmation requirements of section 1129. Sufficient notice of the modification must be given to allow a creditor to change its vote if it desires.

The Court must hold a hearing on whether to confirm the plan. In order for the plan to be confirmed, there are sixteen subsections of Section 1129 that must be satisfied. As a practical matter, there are five subsections that are critical in every case. These include:

i. 1129(a)(1)

This subsection requires that the plan must comply with all applicable provisions of the Code. This includes not only provisions in chapter 11 itself (for example, are claims properly classified and does the plan contain all mandatory elements?) but also other chapters (for example, if executory contracts are assumed and assigned under the plan, does the plan comply with the provisions of section 365?).

ii. 1129 (a)(7)

This is the "best interests of creditors" test. If a creditor rejects a plan, the proponent of the plan (usually the debtor) must show that the creditor is receiving as much for its claim as it would have received in a liquidation of the debtor under Chapter 7 of the Code. For this reason, the plan proponent usually is required to provide a "liquidation analysis" in its disclosure statement that demonstrates what would occur in a hypothetical liquidation of the debtor's assets, with appropriate assumptions on what the likely

proceeds would be and how those proceeds would be distributed to creditors according to the scheme of priorities in Chapter 7. A creditor may challenge the credibility of the proponent's liquidation analysis which would require presentation of expert evidence at a final confirmation hearing.

iii. 1129(a)(8)

This section requires that each class has either accepted the plan or is unimpaired. If this section is not met, then the plan proponent must satisfy the "cram down" provisions of section 1129(b).

iv. 1129(a)(10)

This section is important in the context of "cram down"; that is, the confirmation of a plan over the objection of at least one class of dissenting creditors. It provides that if there is an impaired class of claims (and there almost always is), then at least one such class must have accepted the plan. Unlike section 1129(a)(8), the "cram down" provisions of section 1129(b) cannot save a plan if section 1129(a)(10) has not been satisfied. It is, in reality, the key that unlocks the door to "cram down". If the door remains locked, cram down is not possible.

This section provides that there must be at least some affirmative support for a plan from a class of impaired creditors in order to allow a plan to be confirmed over the objection of another class of impaired creditors. Thus, the plan proponent must always keep in mind who will be its

"consenting impaired class." Because of this requirement, plans sometimes create more than one class of unsecured creditors, with the proponents arguing that there are sufficient "business justifications" to allow multiple classes. As noted above, all creditors within a class must be treated equally and only creditors with the same rights may be in the same class, but the statute does not specifically say that all creditors with the same rights must be in the same class, although many courts require that result.

This issue is brought into sharp focus in smaller cases where there is one large secured creditor and a small number and amount of unsecured creditors. If the secured creditor's claim is greater than the value of the collateral (as is usually the case), then section 506 provides that the claim will be divided into two claims: a secured claim equal to the value of the collateral and an unsecured claim for the deficiency. If this unsecured claim is classified with the smaller unsecured claims, then the likely result is that the large creditor will control both the class with its secured claim and the unsecured class, making cram down impossible.

Section 1129(a)(10) is less of an issue in a case with multiple secured creditors because, as noted above, each such creditor would be separately classified.

v. 1129(a)(11)

This is the "feasibility" test. The section provides that the proponent of

the plan must show that "confirmation of the plan is not likely to be followed by the liquidation, or the need for further financial reorganization" of the debtor. It is not necessary for the plan proponent to guarantee success; rather, the test is whether it is more likely than not that the plan will succeed and the creditors will be paid in accordance with its terms. This is often a hotly contested issue. A debtor that proposes to continue to operate in the future to generate income to pay creditors must demonstrate its ability to do so; this normally takes the form of financial projections. The credibility of those projections is often contested and the court must make the final decision. Are the assumptions reasonable? Do the projections fairly reflect likely revenues and expenses in the future? Are the projections consistent with past performance or are they overly optimistic? Do the projections contain adequate reserves for maintenance and future capital requirements? These are among the questions that may arise.

As it is impossible to predict the future, the feasibility issue is often solved by allowing the plan to be confirmed so long as it contains adequate and immediate protection for the dissenting creditor in the event of failure.

If all the requirements of section 1129(a), except subsection (a)(8), have been met, the proponent may attempt to confirm the plan over the objection of one or more classes of creditors or interests (equity holders). This process is known by the term "cram down", although those words do not

appear in the Code.

The standard for cram down, contained in section 1129(b), is that the treatment of the objecting class must be "fair and equitable" and the plan must not "unfairly discriminate" against the objecting class. While these terms are general, both the Code itself and case law decided over the years inform us what they mean.

The Code sets out the minimum showing necessary to satisfy the "fair and equitable" standard for secured claims, unsecured claims and equity interests. Even if these standards are met, a court could nonetheless decide that the treatment is not fair and equitable but would have to specify its reasons for so concluding.

For a class of secured claims, the plan must provide that the holders of claims retain their liens and receive deferred cash payments equal to at least the allowed amount of claim and with a value, as of the effective date of the plan, at least equal to the value of the collateral securing the claim. What does this mean? As noted above, if the amount of a claim secured by collateral exceeds the value of the collateral, the claim is treated as secured to the extent of the value of the collateral and unsecured for the remainder. Therefore, the first part of the standard is the total amount of cash to be paid over time must at least equal the secured claim. The second part of the standard is more strenuous and subject to difficult issues of proof. It states

that the present value of the cash payments made over time must be at least equal to the value of the collateral. This requires the court to determine an appropriate discount rate that takes into account the time value of money as well as the degree of risk the creditor is asked to assume.

Here is an example. Assume a creditor is owed $1 million and the debt is secured by property worth $600,000. Under section 506, the claim will be "bifurcated" (cut into two pieces) into a secured claim of $600,000 and an unsecured claim of $400,000. The plan proposes to pay the secured portion of the claim $100,000 a year for 7 years. Does this treatment satisfy the "fair and equitable" rule? Certainly, it satisfies the first part of standard because $700,000 is greater than $600,000. Whether it satisfies the second part of the standard depends on what discount rate is determined by the court to be appropriate. For example, if the discount rate is 7%, the present value of the proposed cash payments is approximately $540,000; this is less than $600,000 and therefore insufficient. If the discount rate is 4%, then the present value is greater than $600,000 and would be sufficient. The Court must determine the appropriate discount rate; under most circumstances, it is unlikely that a court would find that 4% is sufficient to compensate the creditor both for the delay in receiving payment and for the risk of non-payment. In such a case, the debtor would have to propose a higher payment or the plan could not be "crammed down."

Are there circumstances where the first part of the standard is more important than the second? Yes, although it is not common. Section 1111(b) allows an under-secured creditor to choose to have its entire claim treated as secured notwithstanding the normal bifurcation under section 506. In the example above, this would mean that the total amount of cash payments must equal at least $1 million although the present value need only equal $600,000. If a creditor chooses this treatment, however, it surrenders its unsecured claim; this removes its ability to "control" the voting in the unsecured class of claims, thereby enhancing the debtor's chances of satisfying the "consenting impaired class" requirement of section 1129(a)(10). The advantage, however, is that the debtor must demonstrate its ability to make payments for the longer period (in this case, 10 years). The longer the payment period, the more likely the court will conclude that the plan is not feasible, as required by section 1129(a)(11) because of the difficulty of supporting the credibility of financial projections over such an extended period.

In addition, the plan may provide the creditor with the "indubitable equivalent" of its claim. This term derives from a reported decision in the 1930's and is most easily satisfied by the simple return of the collateral to the creditor.[48]

A different, and more flexible, rule applies to cramming down a

[48] *In re Murel Holding Corp.,* 75 F.2d 941 (2d. Cir. 1935).

dissenting class of unsecured claims. Such a class is treated "fairly and equitably" if either it receives property with a present value at least equal to the full amount of the claim or if no class junior to it receives anything. Note for the first part of the standard that the creditor need not receive cash but rather may be satisfied by property. Such property may include new securities in the reorganized debtor (such as bonds or shares) so long as they are valued at an amount at least equal to the full value of the claims in the class. If the present value is less than the amount of the claims, the plan may still be confirmed if no junior class receives any distribution. This is known as the "absolute priority rule." Typically, the class that is junior to the unsecured class is the class of equity–i.e., the ownership interests of the debtor. Thus a plan may be confirmed if the dissenting class of unsecured claims receives less than its full value so long as the ownership interests neither receive nor retain anything.

There continues to be considerable debate, over thirty years after enactment of the Code, whether a junior class may receive distributions under the plan if it contributes new value to the reorganized debtor. In 1999, the Supreme Court of the United States undertook to answer the question whether such a "new value exception to the absolute priority rule" existed.[49] However, in its decision, the Court declined to answer the question posed,

[49] *Bank of America National Trust and Savings Association v. 203 North LaSalle Street Partnership*, 119 S. Ct. 1411 (1999).

deciding instead, in effect, that IF such a rule existed, it had not been satisfied by the facts of the case presented. This uncertainty continues to create difficulties for courts, lawyers and businesses involved in reorganization cases.

The standard for cramming down equity is rarely invoked because the class of equity is normally the most junior of all classes. However, in circumstances where there are different types of ownership interests–for example, both preferred and common shares– the plan may be confirmed if the class receives property of a value at least equal to the liquidation or redemption preference, if any, of the securities (as in the case of preferred stock) or if no junior class receives anything.

In practice, these rules form the matrix within which compromises are negotiated. For example, a senior class of creditors may agree that a junior class will receive some amount of return even if the senior class is not paid in full in order to avoid the costs and uncertainty of prolonged litigation on issues of value.

The unfair discrimination standard is applied considerably less frequently than the fair and equitable rule. In a nutshell, the issue is not whether a plan contains discriminatory treatment for creditors in different classes but whether the difference in treatment is unfair. A plan may provide, for example, different treatment for creditors who continue to supply to the

debtor from those who do not, or for creditors whose claims arise contractually versus those that arise from tortious conduct. Congress did not legislate standards for "unfair discrimination", as it did for "fair and equitable", and Courts have struggled in applying the test. What is most important about the test is that it implies by its existence that Congress contemplated that some discrimination among similarly situated creditors would be acceptable–so long as it is not unfair.

As a general rule, a discharge of debts is not available to legal entities under the Code, but rather only to physical persons. This is based on the common sense notion that a legal entity has no need for discharge because its existence can simply be terminated under applicable law. However, an order confirming a Chapter 11 plan of reorganization generally DOES discharge the corporate debtor's pre-petition debts.[50] Section 1141(d). In these circumstances, the legal entity is more like a physical person because it continues in existence and business AFTER confirmation of the plan. In effect, the confirmation order discharges the debtor's pre-petition debts in exchange for the treatment of such debts under the new contract with creditors

[50] The primary exception to this rule is that confirmation of a Chapter 11 plan does not discharge the debtor from its pre-petition debts if all of the following are true: the plan provides for liquidation of all or substantially all of the property of the estate; the debtor does not engage in business after consummation of the plan; and the debtor would not be eligible for a discharge under the liquidation procedures of Chapter 7 of the Code. In addition, there is small number of types of debt that are excepted from discharge in any event. Section 1141(d)(6).

contained in the confirmed Chapter 11 plan.

XI. The future of US Bankruptcy law

The Bankruptcy Code of 1978 replaced a prior law passed in 1938 that itself replaced a law dating from 1898. If a similar forty-year cycle continues, should we expect to see another complete reform by 2018? Some believe that such a major reform is needed to address the highly complex financial structures that are radically different from the financing patterns of the 1970's when the current Code was created and passed into law. In the years since 1978, there have been major reforms in 1984, 1986, 1994 and 2005. However, none of these reforms sought to create a new organic statutory scheme; rather, each was addressed at particular substantive or jurisdictional issues that were either largely motivated by special interest groups or by the necessity to maintain a functioning bankruptcy system. This has resulted in a statutory scheme that is sometimes internally inconsistent and often inflexible where flexibility is needed.

To address these issues, the American Bankruptcy Institute has created a Commission on Chapter 11 that is examining possible reforms to the reorganization process. The Commission consists of highly experienced and respected bankruptcy law experts, including some of the most influential original drafters of the 1978 Code. While Congress did not mandate its creation, the Commission nonetheless will report its findings and

recommendations to that body by the end of 2014.

Another key current issue is the interplay between Chapter 11 and the insolvency of systemically important financial institutions that are not regulated banks.[51] The Chapter 11 case filed by Lehman Bros. was very controversial politically and led to provisions in the Dodd-Frank financial reform law[52] to deal with such non-bank financial giants. That law created an "Orderly Liquidation Authority" process under which the Federal Deposit Insurance Corporation, the body that resolves insolvent regulated banks, may be appointed as receiver to liquidate a systemically important financial institution in an administrative process. The law is still untested three years after passage; there have been no proceedings to date invoking its provisions.

Finally, the efficient functioning of the bankruptcy court system is currently in serious doubt because of a decision by the United States Supreme Court that determined that certain aspects of bankruptcy jurisdiction are unconstitutional.[53] Very briefly, the Court determined that the grant of broad jurisdiction to bankruptcy judges in certain discrete circumstances violated the United States Constitution's general requirements for the selection of

[51] Regulated banks may not be debtors under the Code. Section 109(b) and (d). Rather, there is an administrative procedure under which the Federal Deposit Insurance Corporation (FDIC) acts as receiver to resolve and wind up the affairs of insolvent regulated banks.
[52] Public Law 111-203 (2010).
[53] Stern v. Marshall, 131 S. Ct. 2594 (2011).

federal judges[54] The Court held that the Constitution entitles parties to certain types of suits that are not specifically based upon the Code to have such disputes decided by a judge with "Article III protections" rather than a judge appointed in the manner of bankruptcy judges. Although the Court's opinion stated that the question presented for decision was "a narrow one",[55] the implications of the decision are very broad indeed and are currently under consideration and interpretation by many federal courts across the nation. If the Supreme Court eventually broadens the rationale of *Stern*, the ability of bankruptcy courts to hear and determine chapter 11 cases quickly, efficiently and comprehensively may be substantially undercut. The answer may come in the near future: a case presenting the question whether parties can constitutionally consent to have a bankruptcy judge hear and decide a controversy otherwise within the scope of Stern[56] is set for oral argument on January 14, 2014.[57] We shall see.

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[54] Article III of the US Constitution provides that: "The judges, both of the supreme and inferior courts, shall hold their offices during good behaviour, and shall, at stated times, receive for their services, a compensation, which shall not be diminished during their continuance in office." Article II, Section 2 of the Constitution provides that such judges shall be nominated by the President and confirmed by the US Senate. Bankruptcy judges are appointed by the Courts of Appeal, not the President with confirmation by the Senate; they hold their offices for terms of 14 years, not "during good behavior"; and their compensation may be reduced without violation of the Constitution.

[55] 131 S.Ct. at 2620.

[56] The underlying dispute is a fraudulent conveyance case, a type of dispute that has been decided by bankruptcy courts since they were first established.

[57] Executive Benefits Insurance Agency, Petitioner v. Peter H. Arkison, Chapter 7 Trustee of the Estate of Bellingham Insurance Agency, Inc., US Supreme Court Case

No. 12-1200, on certiorari to the United States Court of Appeals for the Ninth Circuit.