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ABI Commission Report on Changes to Chapter 11

Buongiorno. Grazie Professore Tullio. Modena e la meravigliosa gente che io incontro qui, mi fa davvero sentire come a a casa. Grazie ancora per avermi invitato a partecipare a questa eccitante e importante conferenza.

The bankruptcy laws of the United States have evolved since the late 1800s. Today we are going to discuss a commissioned report[1] based on a three year study for business reorganizations only.

The Report and its Findings

The American Bankruptcy Institute ("ABI") is the United States' largest association of bankruptcy professionals. It is made up of over 12,000 members, including attorneys, auctioneers, bankers, judges, lenders, professors, turnaround specialists, accountants and many others. Founded in 1982, ABI plays a leading role in providing congressional leaders and the general public with non-partisan reporting and analysis of bankruptcy regulations, laws and trends. The ABI

[1] The ABI Commission Report is a great resource for learning the history and interplay of unique terms in the U.S. Bankruptcy Code and can be found at https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h.

commissioned a group of those respected bankruptcy professionals to prepare and publish results of potential changes to the bankruptcy laws concerning businesses.

Professional Fees

The subject of many media reports and headlines when discussing bankruptcy is often the costs of the professional fees. The Lehman bankruptcy case had professional fees of over 1 billion dollars. (The company was holding over 600,000 billion dollars in assets when it filed).

Thus, the Commission reviewed high fees of professionals in chapter 11. And the report admits that the high cost of professional fees in small and medium-sized cases encourages quick sales of the bankruptcy property instead of reorganization. And they found no answer to the problem. Others of the commissions' findings did lend themselves to certain fixes.

Sales

Major corporate bankruptcies are often completed within six weeks through a sale of the business and without a plan of reorganization. Sometimes, senior secured creditors buy the business in exchange for their debt, leaving junior, lessor, creditors nothing or almost nothing. The report recommended changing the laws and procedures governing sales and plan of reorganization approval to ensure that companies aren't sold in the insolvency proceeding at artificially low values. In addition to barring sales within the first 60 days of bankruptcy, the commission

recommends that an entire company shouldn't be sold without the satisfaction of plan-confirmation requirements, including good faith and disclosure of payments and fees.

The commission also proposed an elaborate set of rules to ensure that some creditors are not injured by allowing a low selling price from an unusually fast sale of debtor's property. The commission developed the concept of "redemption option value" to account for the possibility that the company's worth could rise enough within three years. And if the company's value does increase, the secured creditors would be paid in full. A plan of reorganization or sale could be approved over the objection of a creditor class if that class is given the option to be paid in full in three years if the company gains value.

Ordinarily, ownership (shares of stock in the debtor) is wiped out in bankruptcy. The commission would ask for the codification of the "new value exception." The new value exception allows shareholders to retain ownership in the debtor if they contribute value "reasonably proportionate" to the ownership interest they keep.

Rejection of Leases and Contracts

In 2005, the U.S. Congress made a major change in bankruptcy law by requiring the assumption or rejection of real-estate leases within seven months of filing. That change seems to have caused more liquidations early in a bankruptcy

case. The commission recommended allowing a year for the debtor to decide whether to assume or reject a real-estate lease. The Commission also recommended that the Code be amended so that a creditor's right to use a trademark continues even if a license is rejected by the debtor in the bankruptcy case.

Preferences:

U.S. law historically has allowed a debtor in bankruptcy to recover payments to creditors that occur within 90 days of a bankruptcy filing. These are known as "preferences." Preference law was intended to put all creditors an equal footing, so a supplier who has leverage to force payment of debt before bankruptcy comes out no better than other suppliers who do not. The commission said there's evidence that preference actions often do not benefit unsecured creditors. Rather, preferences are considered as a big (emotional, as well as fiscal) problem for creditors because they could mean two losses. The creditor first sustains a loss when the company owing the debt files bankruptcy. And as many as two years later, the creditor then faces a second loss, when a bankruptcy trustee demands the return of payments received within three months of the bankruptcy filing. Sometimes the recoveries only benefit secured lenders or are used to pay administrative expenses of the bankruptcy case and do not go to the creditors of the debtor.

The commission also recommended the statute be modified to require the trustee to conduct "reasonable due diligence" before demanding return of a preference, including laying out the elements of a preference action "with particularity" and known defenses.

Fraudulent Transfers

Current law allows a trustee to sue to recover transfers made with actual intent to hinder, delay or defraud creditors within two years of the bankruptcy filing. The commission would expand this ability to permit suits to recover transfers going back as long as six years before the bankruptcy filing. If that were the law, it's possible the trustee for Bernard L. Madoff Investment Securities Inc. would have been able to maintain lawsuits sufficient to repay the entire $17 billion lost by investors in his record *Ponzi* scheme. (A *Ponzi* scheme is a fraudulent investment operation where the operator, in this case Madoff, paid returns to his investors from new capital paid by new investors, rather than from profit earned by the operator.)

In the liquidation of Madoff, a district court barred the trustee from suing a foreign recipient of a fraudulent transfer where the initial recipient was also a foreigner. The ABI commission would modify the law to permit recovery of payments entirely outside the U.S., as long as the court considers legal principles of international comity.

Labor Unions

The Report found that labor unions and workers need more protection on modification of collective bargaining agreements. Some courts don't give workers any claims if a union contract is modified. The commission would allow unsecured claims for individual workers.

In Pari Delicto

In pari delicto, Latin for "in equal fault," is a centuries-old judge-made law that bars one wrongdoer from suing another. Because the bankruptcy trustees are viewed as stepping into the shoes of the debtors that committed fraud, they are viewed as equally corrupt and can't sue others for the same wrongdoing.

Victims of Madoff's *Ponzi* scheme might have recovered all of losses had this proposal been the law. Unfortunately for them, the legal doctrine known as "*in pari delicto*" prevented the trustee from suing banks and others allegedly complicit in the fraud. In its report, the ABI commission recommended amending the law to allow bankruptcy trustees to bring these cases.

Cramdowns and Voting

Under current U.S. law, half of creditors by number and two-thirds in dollar amount of claims in each class must vote "yes" for a plan to be accepted by that class. The commission advocated doing away with this fundamental feature of the Code. Instead, the commission recommends that a company should be able to

emerge from bankruptcy reorganization even when all creditor classes vote against its plan.

To avoid "delay, cost, gamesmanship and value destruction," the commission endorsed changing current law so an accepting class isn't a prerequisite for confirmation of a plan of reorganization.

On voting, the commission advocated another significant change by endorsing a "one creditor-one vote" rule. This means that a creditor can only have one vote no matter the number of claims and regardless of whether a claim is divided into smaller portions and sold to others.

Small Businesses

85% to 90% of companies filing in Chapter 11 have $10 million or less in assets. These are referred to as small or medium-sized enterprises.

The report explains how existing Chapter 11 law, designed with large companies in mind, and last comprehensively overhauled in 1978, is too slow, too costly and "not working" for small or medium-sized enterprises, dissuading them from even attempting reorganization. The commission recommended ways to make Chapter 11 simpler and less costly for small or medium-sized enterprises while providing tools for them to reorganize effectively.

Important to these enterprises is the "absolute priority rule," which prevents shareholders from retaining their ownership interest in the company. This doesn't

work well with small enterprises (they are almost all “family owned” because there is usually only one shareholder, who is the individual plumber or mechanic) and losing ownership in the company defeats the purpose of reorganization. The commissioners propose allowing existing shareholders to retain ownership, as long as creditors are paid in full within four years of the company’s emergence from Chapter 11. If all creditor classes vote for a plan, existing shareholders retain their stock.

Conclusion

I have just highlighted some of the major recommendations of an approximate 400 page study. While some of the suggestions can be implemented by judicial mandate, most must be part of Congressional legislation. The present U.S. Congress does not appear to have an appetite for overhauling the U.S. bankruptcy code…we shall see what happens and I will report back next year.

Grazie mille.