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FINANCIAL REORGANIZATIONS IN AN ILLIQUID ECONOMY

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I. **Introduction**

Until recently, it was relatively common in the United States for a debtor to receive new money "debtor-in-possession" or "DIP" (*i.e.*, post-bankruptcy) loans at the beginning of its chapter 11 case, and new money "exit" (*i.e.*, post-emergence from bankruptcy) loans upon emergence from chapter 11 bankruptcy, from one or more lenders that may have been already involved in the debtor's capital structure. Third party DIP lenders were attracted to the potentially significant interest payments and fees they could obtain from the debtor in a DIP loan, as well as the safety of the investment (*e.g.*, lenders typically would obtain Bankruptcy Court-authorized first priority liens on substantially all of the debtor's assets and super-priority status for their outstanding principal and interest claims, and other protections). Existing secured lenders of the debtor would have been willing to permit their pre-bankruptcy liens to be "primed" by new money DIP loans so long as either (a) they received sufficient "adequate protection" against the resulting diminution in the value of their liens (in the form of cash payments, replacement liens and other protections), or (b) the value of their collateral exceeded the amount of the outstanding debt (*i.e.*, the lenders' claims are oversecured), such that the risks inherent in a priming lien were manageable. Alternatively, pre-bankruptcy lenders or a subset thereof would provide a DIP loan on terms similar to the pre-bankruptcy loan, thereby priming their own pre-bankruptcy liens. When the global economy was much stronger than it is today, it was more likely either that debtors would be able to provide sufficient adequate protection the liens of their existing lenders, or that the value of the lenders' collateral would exceed the amount of the outstanding debt.

However, as a result of the global economic recession and liquidity crisis, traditional DIP financing facilities from third parties that were not already involved the debtor's capital structure are either inadequate to fund the needs of debtors or totally unavailable. To the extent they are even available to a debtor at all, new money DIP financing and exit financing facilities are likely to be provided by existing creditors of the debtor (normally pre-bankruptcy secured lenders), and not third parties who are strangers to the debtor's capital structure. Because of the illiquidity in the market (and perhaps because they are the only reasonable source of funds for debtors), existing lenders are demanding new and creative terms and conditions on any new money they provide to a debtor, as well as concessions on the terms of the pre-bankruptcy loans. Debtors may be compelled to agree to these terms to stave off liquidation. Indeed, unless the debtor can survive during its restructuring process on its existing cash and can provide creditors who have existing liens on such cash the protection to which they are legally entitled, the debtor may have to agree to these new and creative terms for post-bankruptcy financing, or face liquidation. Unsecured creditors and other constituencies may have no choice but to accede to the existing lenders' demands as well.

In many jurisdictions, post-bankruptcy DIP financing is subject to the approval by a court, other tribunal, administrator or other third party neutral. Moreover, in some jurisdictions like the United States, the debtor cannot grant liens to post-bankruptcy lenders that are senior to existing liens, unless it provides "adequate protection" to holders of existing pre-bankruptcy liens. To the extent a debtor is even able to obtain a proposal for first-priority secured post-bankruptcy financing from a source other than the existing lenders, the existing lenders may oppose the debtor's request to accept that financing on the grounds that their pre-bankruptcy liens are not being adequately protected (*i.e.*, a "priming fight" may occur in the Bankruptcy Court). Debtors may seek to avoid the cost and uncertainty of a priming fight by accepting the terms demanded by their existing pre-bankruptcy lenders.

In determining whether to approve the terms of a proposed post-bankruptcy financing by a debtor's existing lenders, tribunals, administrators and other neutrals may be faced with the choice of either approving onerous terms that are demanded by the existing lenders (which could harm the interests of unsecured creditors and equityholders), or not approving the proposed financing terms and therefore risk the debtor's liquidation if the existing lenders otherwise refuse to loan the debtor new money.

II. Brief Overview of Current Financing Environment in the <u>United States, Germany, the United Kingdom, Italy, Norway and Brazil</u>

A. <u>The United States</u>

In the United States, examples of current alternatives to "traditional" stand-alone new money DIP loans and exit loans include, but are not limited to, the following:

(i) <u>DIP loans from existing secured lenders that includes a full or partial roll-up or pay-down of such lenders' existing pre-bankruptcy debt</u>.

This typically involves the debtor's pre-bankruptcy secured lenders providing a new money DIP loan to the debtor after the bankruptcy case is filed, and as a condition to the DIP loan, the pre-bankruptcy lenders demand that the debtor obtain an order of the Bankruptcy Court that converts some of the existing debt to post-bankruptcy debt. Basically, this means that the pre-bankruptcy debt would be "rolled up" into the post-bankruptcy DIP facility. A roll-up can be structured to occur all at once, or over time as money is actually borrowed.

Roll-ups are controversial because they can negatively affect recoveries for unsecured creditors and can make it much more difficult for the debtor to successfully propose a plan of reorganization to exit bankruptcy. Indeed, not only would this rolled up debt rank higher in payment priority than pre-bankruptcy debt, but the U.S. Bankruptcy Code provides that no chapter 11 plan may be confirmed unless it provides for the payment of all allowed post-bankruptcy claims in cash on the date the plan becomes effective (except to the extent the holder of the post-bankruptcy claim agrees to different treatment). Moreover, if the debtor agrees to a roll-up of the existing lender's pre-bankruptcy debt and if no plan of reorganization results, on liquidation the cost of the roll-up will be borne by the unsecured creditors who will receive a smaller payout than they might otherwise have received if the secured lenders' debt had not been rolled up into post-bankruptcy debt.

For these reasons, parties in interest (such as official unsecured creditors' committees, which typically are appointed at the beginning of chapter 11 cases to act as fiduciaries for unsecured creditors) normally will object to a roll-up and Bankruptcy Courts may balk at approving them. If evidence can be presented that the debtor requires a new money loan and that the terms of the new money loan that are offered by the existing lenders are otherwise reasonable or the best the debtor can reasonably obtain, the Bankruptcy Court may be left with no choice but to approve the roll-up (since the alternative is a liquidation). Additionally, Bankruptcy Courts may be more willing to approve a roll-up if the debtor or the existing lenders can demonstrate through competent evidence that the existing lenders' claims are oversecured and that the chances of the success of a debtor's reorganization is reasonably high.

(ii) <u>Cross-collateralization of the debtor's pre-bankruptcy debt to its existing lenders with post-bankruptcy collateral securing a new DIP loan provided by those existing lenders</u>.

Cross-collateralization occurs when lenders obtain additional security during the bankruptcy case not only for their post-bankruptcy DIP loans, but also for their existing pre-bankruptcy debt. Cross-collateralization provisions are especially attractive to pre-bankruptcy lenders that hold either unsecured or undersecured claims, because they provide these lenders the opportunity to improve their collateral position to the detriment of other unsecured creditors.

For that reason, courts traditionally have questioned the propriety of securing a pre-bankruptcy lender's debt with post-bankruptcy assets. The form of cross-collateralization that has come under the most intense judicial scrutiny occurs when post-bankruptcy DIP lenders who are also pre-bankruptcy lenders require the debtor to secure all or a significant amount of their pre-bankruptcy debt with some or all of the debtor's assets as a condition to extending a new money DIP loan, often without regard to (a) the amount of the post-bankruptcy DIP loan that is actually made by the lender to the debtor, (b) whether the lenders' pre-bankruptcy claim is oversecured or undersecured, or (c) the amount of adequate protection to which such pre-bankruptcy lenders might be entitled based upon the actual usage and diminution of its collateral.

Cross-collateralization is also controversial because a pre-bankruptcy secured lender is not ordinarily entitled to look to assets the debtor obtains after the bankruptcy case is commenced to pay its pre-bankruptcy claim. The U.S. Bankruptcy Code cuts off "after-acquired" clauses in pre-bankruptcy security agreements, and continues the lien under pre-bankruptcy security agreements only in the collateral that is in existence on the date of the commencement of the bankruptcy case, as well as in the proceeds of such collateral if the security agreement covered proceeds. By granting cross-collateralization, the Bankruptcy Court would permit the debtor to dedicate property that would otherwise be available to pay unsecured creditors to the payment of the pre-bankruptcy lenders' deficiency claim. If the pre-bankruptcy lenders' claims are undersecured, the additional collateral prefers the lenders' unsecured deficiency claim over the claims of the debtor's other general unsecured creditors.

Some jurisdictions in the U.S. flatly prohibit cross-collateralization. In jurisdictions where cross-collateralization may be available, certain conditions normally have to be met. These conditions would include: (a) absent the proposed financing, the debtor's business operations would not survive; (b) the debtor would be unable to obtain alternative financing on acceptable terms; (c) the proposed lenders would not accede to less preferential terms; (d) the proposed financing would be in the best interests of the general creditor body; and (e) the debtor's prospects for reorganization are positive.

(iii) <u>Granting the existing lenders a lien on avoidance actions or on proceeds of avoidance actions as "adequate protection" of the lenders' lien on collateral</u>.

A debtor cannot grant liens to post-bankruptcy lenders that are senior to existing liens granted to other creditors, unless the debtor provides "adequate protection" those other creditors against the resulting diminution in the value of their liens. Moreover, during its bankruptcy case, a debtor cannot use cash that had been pledged to its pre-bankruptcy lenders without providing "adequate protection" to the holders of the lien on the cash.

Adequate protection can take nearly any form, such as ongoing interest payments to pre-bankruptcy lenders, financial and operational reporting requirements by debtors, and payment of lenders' professionals' fees. One other very popular method of adequate protection is court-approved replacement liens on post-bankruptcy collateral. Replacement liens are relatively uncontroversial, even though unsecured creditors may prefer that the debtor not grant replacement liens on unencumbered post-bankruptcy assets, as they may reduce the availability of these assets for distributions to unsecured creditors.

Beyond more traditional forms of adequate protection, existing lenders might demand that a debtor grant them liens on the estate's avoidance actions (*e.g.*, preference and fraudulent

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conveyance actions) or on the proceeds of such actions, as a condition for the existing lenders' agreement to provide a post-bankruptcy DIP loan. This is much a more controversial demand for adequate protection than replacement liens, at least from the perspective of unsecured creditors. As an initial matter, a legal issue that arises when considering the grant of a security interest on avoidance actions or the proceeds thereof is whether a pre-bankruptcy lender's blanket lien on all of the debtor's assets extends to avoidance actions. Some Bankruptcy Courts in the United States have held that a blanket pre-bankruptcy lien does not extend to avoidance actions, because such actions only come into existence upon the commencement of a bankruptcy case. These courts have applied a Bankruptcy Code statute that provides that, subject to certain statutory exceptions, property acquired by the estate after the commencement of a bankruptcy case is not subject to a lien resulting from any security agreement entered into by the debtor before the commencement of the case.[2] Under that rationale, avoidance actions exist for the benefit of unsecured creditors, and it would be inappropriate for a debtor to grant liens on such avoidance actions or the proceeds thereof to existing lenders as adequate protection. Other Bankruptcy Courts have held that where a debtor's estate recovers specific property (or the value thereof) that had been secured by a pre-bankruptcy lien through an avoidance action, the security interest may attach to such proceeds. After all, but for the preference or fraudulent transfer the debtor made before its bankruptcy filing, the debtor would have retained the property and the existing lender's lien against that property would have continued.

Generally, courts are more willing to approve liens on a debtor's avoidance actions or the proceeds of avoidance actions if a debtor can demonstrate that exigent circumstances exist and that it cannot obtain necessary financing without granting such liens.

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[2] 11 U.S.C. § 552(a).

(iv) <u>DIP loans from existing lenders that contain other novel terms and conditions that benefit lenders, such as the right of lenders to participate in an exit financing, the right of lenders to receive equity of the reorganized debtor post-emergence, or the right of lenders to backstop or participate in a rights offering for a reorganized debtor's equity</u>.

Upon emergence from chapter 11, a reorganized debtor is expected to succeed financially (or, at the very least, it is not expected to re-enter bankruptcy in the short term), and equityholders of that reorganized debtor stand to benefit significantly from its future success. Indeed, before it can confirm a reorganization plan in a chapter 11 case, the Bankruptcy Court must find that the plan is "feasible." Feasibility means that confirmation of the plan would not be likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor unless such liquidation or reorganization is actually proposed in the plan.

In light of this, as a condition to providing a DIP loan at the commencement of a bankruptcy case, lenders may demand that the debtor grant them a certain percentage of its new equity under any future plan of reorganization. Such a demand may arise in the context of a "pre-packaged" or "pre-negotiated" plan (described in the next subsection), or it may even in the context of a "free fall" bankruptcy case where it is unclear what the ultimate terms of a restructuring might be. Creditors and the unsecured creditors' committee may well object to the lenders' demand to receive equity under a plan of reorganization, particularly if it is possible that the debtor ultimately would be able to repay its DIP loan and pre-bankruptcy loan in cash upon emergence from chapter 11, or if there is a possibility that the debtor could reinstate the lenders' pre-bankruptcy lenders' secured loans or provide those lenders new debt instruments. Creditors would argue that committing to grant equity of the reorganized to DIP lenders at the beginning of the case would be inappropriate, because the debtor should reserve the right to distribute such equity to unsecured creditors or other stakeholders instead.

Instead of demanding an outright grant of equity in exchange for a DIP loan, the debtor's pre-bankruptcy lenders may demand terms in the DIP loan that would entitle them to participate in the debtor's post-emergence exit financing, or that would entitle them to participate in a rights offering for the reorganized debtor's equity. A debtor often will need to obtain cash upon its emergence from bankruptcy. Those debtors may borrow more money upon its emergence from bankruptcy, or they may propose a chapter 11 plan under which investors could invest cash in the reorganized debtor in exchange for preferred and/or common equity through a rights offering. Typically, hedge funds and other types of investors will purchase a debtor's pre-bankruptcy unsecured bonds at a discount to their par value prior to or during the debtor's bankruptcy case, and will use their position as unsecured creditors to participate in a rights offering for a reorganized debtor's equity. Rights offerings typically are "backstopped" by these investors, pursuant to which these investors would agree to purchase any equity that other parties do not purchase in the rights offering. These backstop parties would receive a significant fee in exchange for their commitment to purchase this equity.

Creditors may find the DIP lenders' demand for the right to participate in an exit financing or equity rights offering to be objectionable, because those creditors wish to participate in the exit financing or rights offering themselves, or because they do not want to inhibit or prevent other third party investors from participating. Restriction of competition among investors may lead to less favorable exit financing and rights offering terms for the debtor, and thereby harm creditors.

(v) A post-bankruptcy DIP loan that would allow the debtor to effectuate a pre-packaged or pre-negotiated plan of reorganization that is approved by the requisite majority of the debtor's significant creditor classes.

In the United States, there has been a growing trend of "pre-packaged" and "pre-negotiated" chapter 11 cases, both of which are designed to reduce the amount of time a debtor is in bankruptcy and to reduce the uncertainty inherent in bankruptcy cases. A "pre-packaged" bankruptcy case is one in which the following events occur prior to the bankruptcy filing: (a) the debtor and all (or virtually all) of the impaired classes of creditors negotiate and agree on the terms of a restructuring; (b) the debtor formulates a chapter 11 plan of reorganization and accompanying disclosure statement; and (c) the debtor solicits votes on the plan of reorganization. As soon as possible after the bankruptcy case is filed, the debtor will seek an order of the court confirming the plan of reorganization. A "pre-negotiated" bankruptcy case is one in which the debtor and all (or virtually all) of the impaired classes of creditors negotiate and agree on the terms of a restructuring prior to the commencement of the bankruptcy case, but votes on a chapter 11 plan of reorganization are solicited after the case is filed. Generally, pre-negotiated cases last longer than pre-packaged cases, but both pre-packaged and pre-negotiated cases tend to end sooner than "free fall" bankruptcy cases in which the debtor commences a bankruptcy case without agreements with any classes of creditors.

If a debtor requires additional cash to fund its operations during the pendency of a pre-packaged or pre-negotiated case where existing lenders have consented to the terms of a reorganization, those lenders likely will provide a DIP loan. Often, such new loan would mature relatively soon after it is advanced, because the principal purpose of the loan would be to provide a "bridge" between the time the case is commenced and the time the lenders expect the debtor to emerge from bankruptcy. A short-term bridge loan can provide significant leverage to the existing lenders, because if the pre-packaged or pre-negotiated plan is not confirmed and effectuated prior to the date the loan matures, the debtor would be required to repay or refinance the loan. Thus, to the extent creditors are opposed to the debtor's pre-packaged or pre-negotiated plan, those creditors may object to the bridge loan.

(vi) A fast-track sale of a debtor's assets under section 363 of the Bankruptcy Code, where existing lenders provide only a short-term post-bankruptcy "bridge" loan to permit the debtor to effectuate the sale, if necessary.

Instead of negotiating a plan of reorganization, the debtor and its existing lenders may agree to a sale of substantially all of the debtor's assets as soon as practicable after the commencement of the bankruptcy case. The debtors' existing lenders may demand a quick sale of the debtor's assets after the commencement of the bankruptcy case for various reasons. For example, there may be uncertainty about whether the debtor can successfully reorganize, or the lenders may desire to purchase the debtor's assets "free and clear" of claims and interests in a bankruptcy sale.

In a typical bankruptcy case, assets are sold through a court-supervised auction process that could take weeks, or even a few months, to complete. Similar to the scenario outlined in subsection (v) above, if a debtor requires additional cash to fund its operations during the sale process, the existing lenders may extend a short-term "bridge" DIP loan to permit it to continue operating until the closing of the sale. The lenders likely will be entitled to "credit bid" the balance of the DIP loan and the pre-bankruptcy secured loan toward the purchase price of the assets, if the lenders are interested in purchasing the assets themselves. However, courts in at least two recent cases in the U.S. have ruled that under certain circumstances, secured lenders may not credit bid their secured loans.[3] A bridge DIP loan can provide significant leverage to the existing lenders, because if the sale is not closed prior to the date the loan matures, the debtor would be required to repay or refinance the loan. Thus, to the extent other creditors are opposed to the sale, they may object to the bridge loan.

B. Germany

The major source of financing in German insolvency cases is the Labour Office, which pays a part of the debtor's payment obligation to employees for the three months prior to the formal opening of the insolvency proceeding (*i.e.*, "insolvency pay"). Insolvency pay prior to the formal opening of the insolvency proceeding usually is the major source of a debtor's financing. It generally enables the preliminary administrator to continue the operations of a debtor, as the non-payment of payroll expenses usually puts the debtor into a cash positive position.

After the insolvency petition is filed, the proceedings generally are kept in a preliminary state until this three month period has elapsed. The preliminary administrator may ask the court overseeing the insolvency case to obtain a loan or other financing instrument which, after the formal opening of the case, would have to be repaid by the estate. However, it is rare that preliminary administrators obtain new loans. Usually, most of a debtor's assets are encumbered by the liens of current lenders. Therefore, it can be impossible to find new lenders. For groups of companies, an administrator will usually not be able to use unencumbered assets as collateral for loans obtained by other group companies. It is the current practice that the administrator,

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[3] The Third Circuit in *In re Philadelphia Newspapers LLC*, 599 F.3d 298 (3d. Cir. 2010), held that a plan of reorganization that proposes an auction sale of the debtor's assets may be confirmable, even if it denies the secured creditor with a lien on those assets the right to credit bid its debt at the sale, because the secured creditor would otherwise receive under the plan the "indubitable equivalent" of their secured claim under 11 U.S.C. § 1129(b)(2)(A)(iii). The Fifth Circuit in *In re Pacific Lumber Co.*, 584 F.3d 229 (5th Cir. 2009), also denied secured

with the consent of the existing lenders, use the proceeds from encumbered assets for the continuation of the business with a roll-over of the pre-bankruptcy loan.

After the formal opening of the insolvency proceeding, the administrator is empowered to obtain loans or other financing instruments, which must be repaid by the estate. Depending on the size of the loan, the administrator will usually seek the approval of a creditors' meeting or a creditors' committee. Lack of such approval, however, does not make the loan agreement invalid or unenforceable. Court approval of a loan is not required.

Recently, in some high profile cases, the German government has guaranteed a portion (usually 85%) of the loans that were obtained by administrators. The remaining risk would reside with the banks that extend the loan.

C. Brazil

The Brazilian insolvency regime is governed by Law No. 11,101, of February 9, 2005 (the Brazilian Bankruptcy and Reorganization Law, or "LFR"), which introduced a Chapter 11-oriented judicial reorganization proceeding (known as a "Recuperação Judicial"). Although it creates a friendlier environment for credit than the previous law, the law is not comprised of sufficient regulation on financing issues. The LFR provides that any post-bankruptcy debts have priority over most pre-bankruptcy claims, but does not provide for DIP financing with first priority liens over all other creditors, as in the U.S.

Court approval is not required for a debtor to obtain a post-bankruptcy loan (which loan would not be secured with a first priority lien over all creditors), unless the debtor has been removed from management. In that case, the Creditors' Committee would submit the new financing for Court authorization.

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noteholders the right to credit bid in a sale of their collateral under a plan of reorganization on the ground that they

In view of its recent enactment, the LFR still has not been tested relative to several issues – including those of financial nature – so the market is still concerned with investing in the area, due to the risks involved. In light of this scenario, the financing of companies undergoing reorganization is mostly secured via fiduciary sale or assignment ("alienação fiduciária" or "cessão fiduciária"), which are excluded from the insolvency procedure as a whole. By means of these two tools, creditors hold title of the collateral, in trust, until the loan is repaid. In the event of default, the creditor has the absolute right to acquire full ownership over the collateral, repossessing and disposing of said assets upon judicial or private sale, and using proceeds obtained therefrom to satisfy the debt and any expenses arising out of the sale.

Brazil recognizes the doctrine of substantive consolidation, by which the debtor's assets could be brought into its parent company's bankruptcy proceedings. However, as a matter of fact, Brazilian courts have rarely decided cases on the matter. Although cross-stream and upstream guarantees constituted between affiliate companies in a holding group or from subsidiaries to parent companies are valid when granted before insolvency, a financing involving a multi-national group of companies undergoing reorganization would be problematic because Brazil has not yet adopted the UNCITRAL Model Law on cross-border insolvency and has remained silent on the matter. Hence, Brazilian courts cannot execute any cross-border insolvency protocols or other types of arrangement with foreign courts. Therefore, creditors of the Brazilian subsidiary could oppose any financial structure in which Brazilian entities provide guarantees to the benefit of non-Brazilian affiliates.

In a recent judicial reorganization, one of Brazil's largest slaughtering companies issued commercial notes backed by the surety/guarantee of one of the companies undergoing

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would receive under the plan the "indubitable equivalent" of their secured claim.

reorganization. In addition, the loan was backed by the fiduciary sale of all properties and assets, except for receivables, financial investments and assets already pledged by other pre-bankruptcy secured creditors. In addition to the priority granted by the LFR, the new lenders shared the guarantee given to the pre-bankruptcy and/or post-bankruptcy creditors, according to the seniority defined among them, in accordance with the provisions of the Guarantee Sharing Instrument. The notes were granted priority in the proceeds from the execution of the properties given as collateral.

D. <u>United Kingdom</u>

In the United Kingdom, no new significant financing techniques for insolvencies have been created to handle the current illiquidity in the global markets. In the United Kingdom, when a company files for an administration, its existing unused debt facilities are normally cancelled by operation of the debt instrument. There is no legislative override annulling such contracts. Any new lending is, in the first instance, a personal obligation undertaken by the administrator for which he is entitled to an indemnity from the unpledged assets of the company. That indemnity would rank as a cost of the proceedings. Such loans must be approved by the court to be a valid cost.

In practice, this means that new money lending by new lenders, in the manner of a classic U.S. DIP loan is almost unheard of. Such funds that are available are provided by existing secured lenders as a bridge to a realization of the secured assets. These will only be offered and accepted in cases where it is nearly certain that the realizations will exceed the secured lending and the additional loan.

It is for this reason that most administrations try to sell the assets – or at least a significant proportion of them – to raise cash as quickly as possible. The current trend toward pre-packaged administrations should be seen in this context and indeed the absence of on-going financing is often cited as the main reason why a pre-packaged solution is justified. For the same reason, offers from parties to buy inventory for an up-front payment will be of interest to an administrator.

Even when funds can be raised by the partial sale of assets, the administrator cannot use these for ongoing trading unless he can justify a benefit for the creditors in doing so.

The government will provide a limited amount of support for termination payments for employees. In effect, the government will pay the employees (up to annually reviewed limits) and step into the employees shoes as a claimant in the process. While the government's assistance in this regard is very useful to employees whose employment is terminated, this assistance is rarely of significant impact on the strategy for the administration.

E. Norway

In Norway, the basic provisions on bankruptcy and reorganization procedures are found in the Act on Debt Arrangement and Bankruptcy (the Bankruptcy Act) and the Act on Creditors' Recovery (the Recovery Act), both of 1984. The Bankruptcy Act sets out the provisions of the three formal procedures available under Norwegian insolvency law: voluntary composition, compulsory composition and bankruptcy. The first two procedures are designed to encourage a settlement of debts between the debtor and its creditors, while the third aims to realize the assets and distribute the proceeds thereof. The underlying legal framework for both the composition procedures makes the procedures themselves quite complicated and hard for the debtor to succeed. As a result, the most common form of restructuring insolvent companies is by use of private out of court restructurings. Such proceedings are not subject to any special legislation but are based on the general rule that debtors are free to enter agreements with their creditors.

Certain ground rules are, however, often used to legitimize the effort and avoid liability for company managers and directors. For example, such liability can be incurred if significant new debts (regardless of source) have been incurred, limiting the possibility of unsecured creditors to gain coverage.

Under a composition procedure, the debtor is not entitled to incur or replace debt without the consent of an established creditor's committee. The procedure implies a debt settlement (composite agreement) and a reorganization of business activities, and an important part of achieving a binding arrangement implies new funding from owners/shareholders and existing lenders. A certain majority of the creditors is needed to achieve a binding arrangement.

Bankruptcy proceedings imply a liquidation of all assets and cessation of the business. The assets will be realized and the proceeds thereof distributed to the creditors in a strict order of ranking. If ongoing business is conducted by the bankruptcy estate, it will only be in a very limited and restricted timeframe to prepare for the sale of business as such. An administrator would not seek any new lending, as this would be a cost of the proceeding of which a breach would imply an insolvent bankruptcy estate and personal liability for the administrator for the damages caused. However, funds occasionally are provided by existing secured lenders as a short bridge to a realization of the secured assets.

No special financing techniques for out-of court insolvencies has been developed, and all new agreements entered into by the debtor require consent from all creditors involved, in principle irrespective of their priority and size.

F. Italy

Under Italian insolvency law, a company in pre-insolvent composition can enter into a loan agreement, and grant security interests in their assets, so long as these transactions are authorized by the judge having jurisdiction over the company's composition. Loans that are authorized by the judge have, *per se*, a first priority on the unencumbered assets of the debtor. Traditionally, companies in pre-insolvent composition very rarely have obtained loans, mainly because pre-insolvent compositions are generally aimed at liquidating the subject companies.

Nevertheless, recently the pre-insolvent composition scheme has been utilized to restructure companies in financial distress. Accordingly, it is possible that companies in pre-insolvent compositions will seek and obtain post-bankruptcy DIP financing. Generally, successful pre-insolvent compositions aimed at restructuring a company in financial distress up until now have not required large amounts of working capital. Indeed, pre-insolvent compositions are most feasible for holding companies that do not have significant working capital requirements.

In general terms, a guideline that a judge may apply in authorizing new loans in pre-insolvent composition is that the priority rights acquired by the new lender should not prejudice the expected treatment of the existing creditors. A couple of examples may be used to describe the current debate in Italy:

(i) A company that has entered a pre-insolvent composition might obtain a revolving facility secured by receivables accrued by the company after the filing of the pre-insolvent composition. If these receivables are duly paid by the customers, the new money facility will be repaid and the existing creditors' expected treatment would not be prejudiced, while the goodwill of the company (and its value as an "ongoing business") would be preserved;

(ii) A more complex situation is the one of a company that has entered a pre-insolvent composition and that has requested the judge approval for a bridge loan to refinance the outstanding indebtedness of a subsidiary. Provided that (i) this bridge loan is part of the plan proposed to the creditors; (ii) creditors have voted in favor of the proposal, (iii) the bridge loan prevents the insolvency of the subsidiary and (iv) the amount of the loan is less than the equity value of the subsidiary; it might be argued that the bridge loan granted to the parent company in pre-insolvent composition can be authorized by the judge since it has not prejudiced the expected treatment of its creditors. In this scenario, an easier structure may be represented by a bridge loan granted directly to the subsidiary and secured by its shares owned by the parent company in pre-insolvent composition. However, in this case the lender will not have the first priority right on the unencumbered assets of the company in pre-insolvent composition, though it will obtain a security on the shares of the subsidiary whose value depends on the financial solidity of the subsidiary itself.

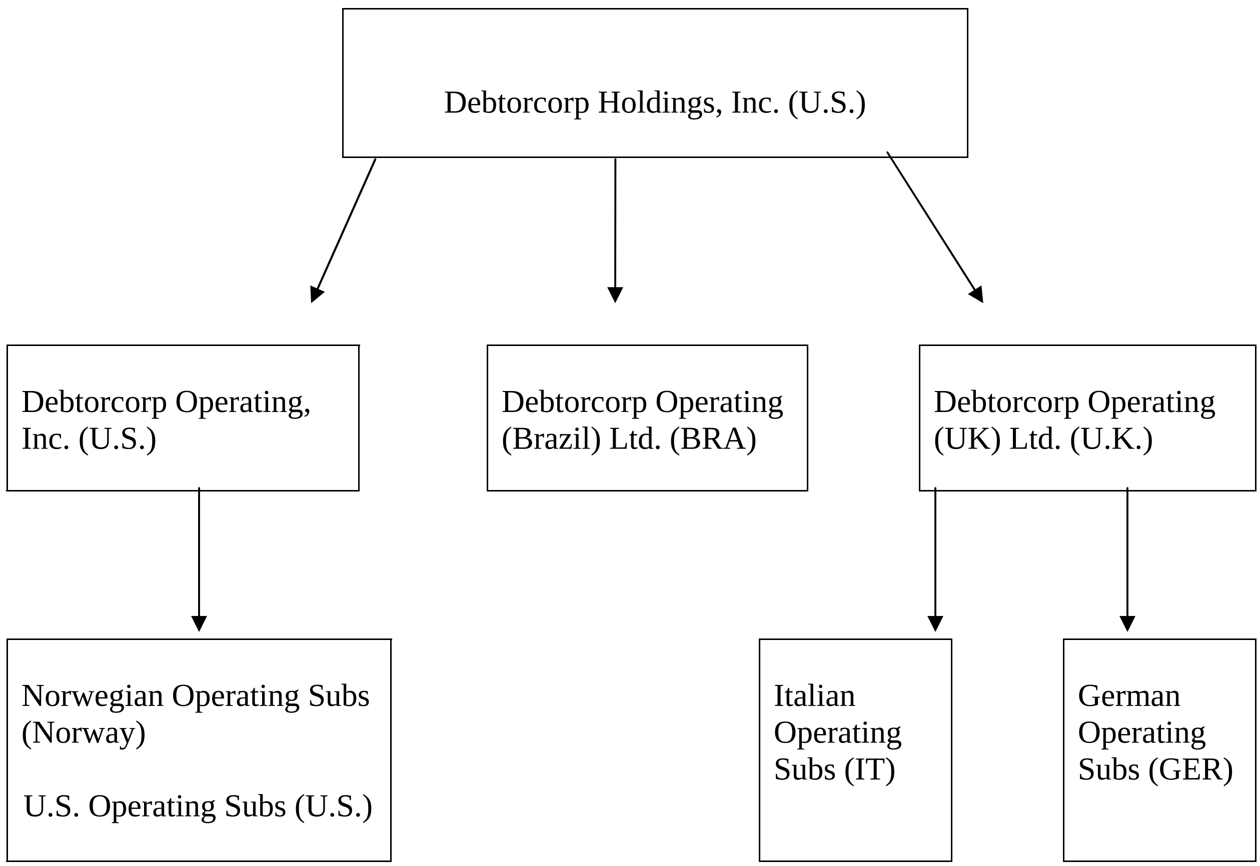
III. Application of These Financing Alternatives to a Hypothetical Multi-National Debtor

A. Overview of the Hypothetical Debtor

"Debtorcorp" is a large multi-national enterprise that manufactures and sells goods in most regions of the world. The ultimate parent entity is a U.S. corporation, and several operating entities are U.S. corporations. Debtorcorp also has significant operating entities that are incorporated in (and operate in) the United Kingdom, Germany, Italy, Norway and Brazil. Finally, there are various operating subsidiaries that are incorporated in other countries.

As a result of the global economic downturn, the inability of many Debtorcorp entities to satisfy their upcoming interest payment obligations, and other significant obligations such as environmental liabilities, pension and retiree benefits, Debtorcorp recognizes its need to reorganize. Negotiations to restructure Debtorcorp's obligations out of court have failed.

Debtorcorp operates as an integrated enterprise. Accordingly, if a substantial number of Debtorcorp operating entities were to liquidate, it would have a materially negative effect on the other entities. Accordingly, Debtorcorp will try to avoid instituting any proceedings that would force any of its significant operating entities to liquidate. A simplified corporate structure chart for the Debtorcorp enterprise is below:



B. <u>The Debtorcorp Enterprise's Significant Liabilities</u>

Below is a brief description of Debtorcorp's significant liabilities:

(i) A $2 billion secured term loan facility, in which Debtorcorp Operating Inc. is the borrower, and Debtorcorp Holdings, Inc. and the U.S. Operating Subs are guarantors. This loan is secured by a lien on substantially all of the assets of the borrower and all guarantors. This loan is undersecured.

(ii) A €500 million secured facility, in which the German operating subs are the borrowers. This loan is secured by a first lien on substantially all of the assets of those subsidiaries. This loan is undersecured.

(iii) A €300 million secured facility, in which the Italian operating subs are the borrowers. This loan is secured by a first lien on substantially all of the assets of those subsidiaries. This loan is oversecured.

(iv) £ 500 million principal amount of outstanding secured bonds issued by Debtorcorp Operating (UK) Ltd. These bonds are secured by a first lien on substantially all of the assets of Debtorcorp Operating (UK) Ltd. These bonds are oversecured.

(v) There are significant environmental liabilities, pension, retiree benefits, and labor contract obligations at virtually all of Debtorcorp's significant operating companies.

(vi) There are significant intercompany loans between the Debtorcorp entities.

C. <u>The Various Insolvency Proceedings</u>

The parent company and the U.S.-based Debtorcorp operating subsidiaries each will file voluntary petitions for relief under chapter 11 of the United States Bankruptcy Code. Additionally, the U.K., German, Italian, Norwegian and Brazilian operating subsidiaries each will commence insolvency proceedings under these respective countries' insolvency laws that would permit these entities to reorganize.

In addition to the foregoing proceedings, the appropriate representatives of the operating companies in each jurisdiction will request extraterritorial recognition of their proceedings in other jurisdictions. For example, the duly-appointed representatives in the non-U.S. insolvency proceedings will request recognition of the non-U.S. insolvency proceedings as "foreign main proceedings" under chapter 15 of the United States Bankruptcy Code.

D. Establishment of a Cross-Border Insolvency Protocol

To address procedural matters involved in Debtorcorp's multiple insolvency proceedings, at the beginning of the insolvency cases, Debtorcorp and its various stakeholders should negotiate and formulate a cross-border insolvency protocol. The principal purpose of a cross-border insolvency protocol is to coordinate effectively these multinational insolvency administrations for the benefit of all stakeholders. Such a protocol should be designed to facilitate communications and proceedings among the different courts and other tribunals that have jurisdiction over the numerous insolvency proceedings.

Debtorcorp's cross-border insolvency protocol may address the following procedural issues, among others:

- Allocation of jurisdiction of the various courts and the rights of various parties-in-interest to be heard.
- Recognition of each court's rulings by other courts.
- Coordination of the filing of creditor claims and the allowance/recognition of such claims.
- Coordination of borrowing authority of the various debtor entities.
- Coordination of approval of asset sales and other significant transactions and actions outside the ordinary course of business.
- Coordination of distributions to creditors.
- Coordination of creditors' meetings.
- Coordination of approval of reorganization plans, schemes of arrangement and similar restructuring documents.

However, courts in some jurisdictions (such as Brazil, as described above) cannot execute cross-border insolvency protocols or other types of arrangement with foreign courts. This will create difficulties for companies like Debtorcorp, which have significant Brazilian operations and which have subsidiaries that commenced insolvency cases in Brazil.

IV. Potential Financing Issues in Debtorcorp's Multiple Insolvency Proceedings

Below are three selected potential financing scenarios that could arise in Debtorcorp's insolvency proceedings worldwide, as well a description of certain issues that may arise under each scenario.

A. Scenario One

Debtorcorp's U.S. entities are unable to obtain new money DIP financing from a third party lender. The administrative agent for the $2 billion U.S. secured term loan facility suggested that the existing lenders may provide a post-bankruptcy DIP loan in the amount of $500 million, to provide the entire Debtorcorp enterprise (both U.S. and non-U.S. entities) with sufficient liquidity to operate during the course of their insolvency proceedings. In exchange for this $500 million DIP loan, the administrative agent requests that $500 million of the existing $2 billion pre-bankruptcy U.S. facility be rolled up into post-bankruptcy debt in the U.S. cases. It also requests that the obligations under the DIP loan be secured by a first lien on the assets of the U.S. operating entities and either a first lien or a junior lien on substantially all of the non-U.S. operating entities' assets.

Certain Possible Issues:

(i) The $500 million roll-up requires approval of the U.S. Bankruptcy Court, and numerous issues can arise in connection with Debtorcorp's and the lenders' request to approve the roll-up. In connection with the court approval process, creditor constituents will be given the

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opportunity to object to the roll-up and all other aspects of the proposed DIP loan and any adequate protection package that Debtorcorp may seek to provide to the lenders. These creditor constituents may very well find the roll-up to be objectionable in this case because the $2 billion loan is undersecured and because it is not reasonably clear that Debtorcorp can successfully reorganize. If the roll-up were granted, it would be even harder for Debtorcorp to propose a confirmable chapter 11 plan of reorganization, because the U.S. Bankruptcy Code requires that a plan of reorganization provide for the payment of all allowed post-bankruptcy claims in cash on the date the plan becomes effective (except to the extent the holder of the post-bankruptcy claim agrees to different treatment). Thus, Debtorcorp would need to repay or refinance $500 million of additional post-bankruptcy claims on the effective date of a chapter 11 plan, unless the requisite number of holders of the $2 billion loan agree to a distribution other than full payment in cash of the rolled-up claim.

Nevertheless, even if the other creditor constituencies strenuously object to the requested roll-up, if Debtorcorp introduces sufficient evidence that it requires a new money loan to avoid a liquidation, and that the terms of the new money loan are otherwise reasonable or the best that Debtorcorp can reasonably obtain, the Bankruptcy Court may be left with no choice but to approve the roll-up.

(ii) Another issue can arise if the lenders seek to secure their $500 million new money DIP loan with a first lien on the assets that presently secure Debtorcorp's U.S. entities' pre-bankruptcy debt to other creditors (*i.e.*, if the lenders request to secure the DIP loan with a "priming" lien on those assets). In that case, Debtorcorp must demonstrate to the Bankruptcy Court both that it was unable to obtain a loan without granting a priming lien on those assets, and that it can provide adequate protection to the other creditors whose liens are being primed. As noted above, adequate protection may take any form, but a priming fight will occur if these other secured creditors believe that the adequate protection package Debtorcorp is offering is insufficient. On the other side of the debate, unsecured creditor constituencies (such as the official unsecured creditors' committee, which owes fiduciary duties to Debtorcorp's unsecured creditor body) may argue that the adequate protection package being offered to secured creditors is too generous.

(iii) Additional issues would arise if the lenders request that Debtorcorp pledge the assets of its non-U.S. operating entities as collateral for the U.S. DIP loan (either with a senior priming lien or a junior lien), or if the lenders request that non-U.S. operating entities guaranty the U.S. entities' obligation to repay the DIP loan. Many (if not all) of non-U.S. subsidiaries that would grant liens or provide guaranties in favor of the U.S. DIP lenders would need to obtain the requisite approvals from the appropriate tribunals, administrators or creditor groups to grant liens and/or guaranties to secure the U.S. DIP loan. It would not be possible for Debtorcorp subsidiaries in some jurisdictions to grant liens (senior or junior) to secure the U.S. DIP loan if the law in those jurisdictions does not permit the granting of such liens.

Even if the law were to permit these subsidiaries to grant liens or guaranties to the U.S. lenders, creditors of the non-U.S. operating subsidiaries can be expected to object to the lenders' request, since the assets that would otherwise form the basis of their recoveries would be pledged to lenders of Debtorcorp's U.S. entities instead. These objections may be raised by various different stakeholders of Debtorcorp's non-U.S. entities, such as secured lenders, trade creditors, government entities with environmental and other claims, employees and retirees. In response to these objections, Debtorcorp would likely assert that the DIP loan would benefit all Debtorcorp entities around the world, as the loan provides the necessary liquidity to keep the enterprise running. The corollary of that argument is that without the DIP loan, the entire enterprise would collapse because of a lack of liquidity and the lack of available financing from other sources. Thus, while the stakeholders of the non-U.S. entities might conceivably be harmed by the grant of liens and/or guaranties, the alternative (the possible liquidation of the entire enterprise) would be much worse.

Tribunals may refuse to permit the non-U.S. subsidiaries to grant liens or guaranties, in light of the objections that are raised. Alternatively, these tribunals may authorize the liens or guaranties, but require the U.S. lenders to exhaust all available recourse against the U.S. entities and assets first, before they exercise any rights against assets of the applicable non-U.S. subsidiaries. If the U.S. lenders cannot obtain liens or guaranties from certain non-U.S. subsidiaries, they will have to consider whether they remain willing to provide a new DIP loan to the U.S. Debtorcorp entities, or whether they would be willing to permit the proceeds of the DIP loan to be shared with Debtorcorp entities that do not grant liens or a guaranty.

B. Scenario Two

Debtorcorp's U.S. lenders are not willing to provide enough DIP financing to provide sufficient liquidity to the entire Debtorcorp enterprise (rather, they will lend an amount much smaller than $500 million, for use only by the U.S. entities). To fill the gap, the agents for the existing non-U.S. secured facilities suggested that existing lenders may make loans to the non-U.S. Debtorcorp entities, to provide those entities with enough cash to continue their insolvency proceedings. The new money loans would prime all existing pre-bankruptcy liens in each country.

Certain Possible Issues:

(i) As noted above, many (if not all) of non-U.S. subsidiaries that agree to grant liens or provide guaranties in favor of the DIP lenders likely would need to obtain the requisite approvals from the appropriate tribunals, administrators or creditor groups to grant liens and/or guaranties to secure the U.S. DIP loan. To varying degrees, stakeholders would have an opportunity to object to the Debtorcorp entities' request to obtain these new loans. As described above, in certain jurisdictions, insolvency laws do not permit (or even contemplate) post-bankruptcy loans that are secured by first priority "priming" liens or even post-bankruptcy loans that are only secured by junior liens. Brazil and the United Kingdom are examples of jurisdictions where a debtor would not obtain post-bankruptcy loans that are secured by first priority liens. Thus, it likely will be impossible for the Debtorcorp entities that commenced insolvency proceedings in those jurisdictions to obtain loans that are secured by first priority liens after the commencement of insolvency proceedings. It may not even be possible for Debtorcorp entities that commenced insolvency cases in certain jurisdictions to obtain post-bankruptcy loans at all. In those situations, lenders might permit the Debtorcorp entities to continue operating their businesses with cash on hand and with cash they generate through post-bankruptcy operations. Otherwise, these entities may be forced to liquidate.

(ii) In other jurisdictions such as Germany, the major source of funding comes from the government (as noted above, in Germany such funding comes from the Labour Office in the form of insolvency pay to employees during the three months prior to the formal opening of the insolvency proceeding). Debtorcorp may need to rely on the government assistance in jurisdictions such as Germany, particularly since the existing €500 million German secured facility is already undersecured and there are no unencumbered assets that can be pledged to secure a new loan to the German entities.

C. Scenario Three

The administrative agent for the $2 billion U.S. secured term loan believes that the U.S. entities cannot be successfully reorganized. It suggests that Debtorcorp engage in an expeditious sale of the U.S. operating companies' assets under section 363 of the Bankruptcy Code, and the lenders are willing to lend $10 million of new money to provide the Debtorcorp enterprise with enough cash to operate in chapter 11 while it effectuates the sale. The existing lenders might credit bid their $2 billion debt in the sale. Debtorcorp does not believe that a sale of the U.S. entities only would generate maximum value for creditors, since Debtorcorp is an integrated enterprise. Rather, Debtorcorp believes that if a sale were to occur, the entire enterprise should be sold as a unit. If that is not possible, Debtorcorp believes that it would be possible (though not practical) to sell their assets in each country separately.

Certain Possible Issues:

(i) Both the sale of Debtorcorp's U.S. assets and the $10 million DIP loan requires the approval of the U.S. Bankruptcy Court, and parties will be given an opportunity to object. In a typical sale of assets in a U.S. bankruptcy case, the debtor would find a "stalking horse" bidder (which would make the first binding bid for the assets) and then run an auction process under the auspices of the Bankruptcy Court, in which the debtor would solicit higher and better bids than that of the stalking horse. If another bidder prevails in the auction, the stalking horse bidder may be entitled to a break-up fee and reimbursement of its expenses (if such fee and expense reimbursement are approved by the Bankruptcy Court).

Debtorcorp and the lenders might request a shortened auction process, so that the sale can close quickly. Courts typically balk at approving sales on significantly expedited timelines, since a longer sale process may lead to a more robust auction, and thus a higher price for the assets. In requesting Bankruptcy Court approval of a sale on an expedited timeline, Debtorcorp and the lenders may need to rely on a "melting ice cube" theory to justify the swiftness of the proposed sale process. Under that theory, the assets would have to be sold very quickly because there is little chance of a successful reorganization and the enterprise's value is diminishing quickly. Accordingly, not pursuing a quick sale could prove to be disastrous for creditors and other stakeholders.

Debtorcorp's other stakeholders in the U.S. and around the world may object to a sale, believing that Debtorcorp is a viable business that can successfully reorganize. Creditors may believe that the price Debtorcorp can receive in any sale in this current global economic environment is much less than the "true value" of the company. The potential sale price may be further depressed if the sale is completed on an expedited basis, because potential bidders who need time to perform due diligence may not be able to submit bids prior to the auction date. Other stakeholders, such as employees, retirees and vendors may object to the concept of a sale, since new ownership brings significant uncertainty surrounding future employment opportunities, the fate of the company's pension and other retiree benefits plans, and future vendor-customer relationships. These creditors and other stakeholders of the U.S. entities may also object to the $10 million DIP loan, to the extent its terms require a sale on an expedited timeframe or have an early maturity date.

(ii) Parties with certain specific types of claims against Debtorcorp, such as environmental claimants and tort plaintiffs, may object to the sale. This is because Debtorcorp would propose that the sale be "free and clear" of all liens and other interests in Debtorcorp's assets. Under the U.S. Bankruptcy Code, a debtor may sell its assets free and clear of interests in those assets if any one of the following conditions applies: (a) applicable non-bankruptcy law permits sale of property free and clear of interests; (b) the entity holding the interest consents; (c) the interest in question is a lien and the price at which the assets are to be sold is greater than the aggregate value of all liens on the assets; (d) the interest is in bona fide dispute; or (e) the entity holding the interest could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest. Currently, it is not clear under existing caselaw in the U.S. whether a sale in a bankruptcy case can extinguish successor liability claims against the purchaser of Debtorcorp's assets. It is particularly unclear whether a sale in a bankruptcy case can extinguish successor liability claims of future plaintiffs who were not injured or who were not aware of their injuries or claims prior to the sale.

(iii) Another issue would arise if minority lenders object to a sale of Debtorcorp's assets, but the majority lenders approve of the sale. As noted above, a debtor may sell its assets in a bankruptcy case "free and clear" of liens and other interests if the entity holding the interest consents. There has been some recent litigation in the U.S. on the issue of what qualifies as "consent" to a free and clear sale, when the lien is held by a collateral agent on behalf of a syndicated lender group. The issue that has been presented to courts is whether the collateral agent or administrative agent, with the consent of the requisite number of lenders under the terms of the underlying debt documents, can consent to a free and clear sale; or whether the consent of *all* the lenders required. Courts rely on the terms of the debt documents to answer that question. In cases where the underlying debt documents provide that a collateral agent or administrative agent may exercise remedies and release liens after an event of default, upon the direction of a specified requisite number of lenders, some courts have ruled that the agent may consent to a free and clear sale on behalf of all lenders, even if some lenders do not consent to the sale. These courts have reached this conclusion even where the underlying debt documents also provide that unanimous lender approval is required for waivers, amendments, supplements or modifications of the documents, reasoning that a sale of assets is not a "waiver, amendment, supplement or modification" of the debt documents.

(iv) If Debtorcorp attempts to sell all of its worldwide assets as a unit, it would have to obtain the requisite approvals of the courts and other tribunals that have jurisdiction over the different insolvency proceedings. Even if an effective, robust cross-border insolvency protocol is established, obtaining all of these approvals can be a long and daunting process, and it would be difficult, if not impossible, to obtain these approvals in a short timeframe.