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**IF WE WERE DOING IT AGAIN: REFLECTIONS ON
IMPROVING CHAPTER 11 AND CONTRASTING
INTERNATIONAL EXPERIENCES**

By

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Overview

- **Original design of chapter 11**
- **Changes since 1978 in the law and the credit environment and their effect on the functioning of a fair and efficient reorganization system**
- **What would we do differently to account for these changes?**

Chapter 11's Original Design

- **Rescue companies from financial distress**
 - Preserve jobs
 - Preserve investments
 - Provide a fair recovery to creditors and shareholders
- **Rescue system requires:**
 - **Collective action**
 - All parties in interest at the same negotiating table
 - **Operational restructuring tools**
 - Sales, borrowings, preservation of contracts
 - **Financial restructuring tools that would bind all parties in interest**
 - Prevents hold outs
- **Chapter 11 has all these features**

Chapter 11's Original Design, cont'd

- **Additional features**
 - Power to keep all parties at the same negotiating table (exclusivity)
 - Reduce debtors' disincentives to using the system
 - Debtor in possession
 - Plan exclusivity
 - Relaxation of the absolute priority rule, among others)
- **Assume creditor democracy and self-determination:**
 - Creditors' only exit was through a reorganization plan
 - Creditors had to choose between the restructuring table and giving up any recovery

Change and Its Effects on Chapter 11

- **Pervasive security interests**
- **Preplan going concern sales**
- **Claims trading**
- **Derivatives and securitizations**
- **Statutory changes**

Change and Its Effects on Chapter 11

- **Pervasive security interests (UCC Article 9)**
 - Permits a single group to dominate the chapter 11 process
 - One creditor (or relatively small group) largely has a veto right
 - Reduces the need for all parties to sit at the same negotiating table
 - Impairs collective action and consensual process for other creditors and shareholders
 - Fosters a going concern sale as a quick exit strategy for secured lenders

Change and Its Effects on Chapter 11, cont'd

- **Sale of a company as a going concern rather than internal reorganization to realize value for the estate**
 - Court decisions permitted early stage sales without a reorganization plan
 - Financial and strategic buyers learned to use the chapter 11 sale process to acquire “clean” title to distressed properties
 - Permits faster monetization of value for the estate, but . . .
 - Cuts off the ability to turn around a business for the benefit of the existing creditors
 - Option value in the business goes to the buyer

Change and Its Effects on Chapter 11, cont'd

- **Active claims trading market**
 - Gives “legacy” creditors an alternative exit strategy, allowing them to crystallize losses, but . . .
 - Usually at a lower value, by transferring risk of success to the buyer
 - Claims buyers are often savvier than bond or trade claim sellers, risking unequal information and bargaining power
 - When combined with pervasive security interest, permits unregulated third party M&A strategies
 - Company in chapter 11 is almost automatically “in play”
 - *See, e.g., In re Ion Media*, 419 B.R. 585 (Bankr. S.D.N.Y. 2009)

Change and Its Effects on Chapter 11, cont'd

- **Derivatives and securitizations impair “creditor democracy” principle**
 - Permits hedging and divorcing economic and voting interests
 - CLO’s and CDO’s may be restricted from participating
- **Globalization and multi-jurisdictional corporate groups**
 - Make reorganization more difficult, fostering quick sales
 - UNCITRAL and EU Convention have mitigated adverse effects

Change and Its Effects on Chapter 11, cont'd

- **Finally, some statutory changes have impaired the collective action principle**
 - Special interest provisions
 - Landlords
 - Suppliers
 - Financial contracts

Ideas for Modernization of Chapter 11

- **Require greater transparency of claims holdings and intentions (similar to U.S. securities laws) and of potentially conflicting interests**
 - Especially important in evaluating voting motivations
 - Of claims on a plan
 - Within a creditor group (for example, in a syndicated loan group)
 - Amended Rule 2019 may accomplish this for plan voting

Ideas for Modernization of Chapter 11, cont'd

- **More nuanced rules on pre-plan sales of assets**
 - Who pays for the process?
 - Do different distributional rules apply from those that apply outside of bankruptcy?
 - Treatment of secured claims
 - Protection of employees, vendors, taxing agencies, special creditors
 - Provide protection against undervaluation in a forced, rapid sale
 - Protect minority against overreaching majority
- **Greater cross-border powers for multi-jurisdictional groups**

Ideas for Modernization of Chapter 11, cont'd

- **More nuanced rules on the differences in treatment among providers of**
 - Capital
 - Goods and services
 - Labor
 - Involuntary claims such as taxes and tort claims
 - E.g., Critical vendor orders, protection of employee claims
- **Effect on secured credit?**
 - Protection of secured credit may result in too much credit, but reducing protection may reduce credit availability and hamper recovery
 - Ultimately an economic, not a bankruptcy, policy

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