INTERNATIONAL INSOLVENCY INSTITUTE
Tenth Annual International Insolvency Conference

Rome, Italy

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

By
Richard Levin
Cravath, Swaine & Moore LLP
New York
June 7-8, 2010

©International Insolvency Institute 2010. All rights reserved.
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
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
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)
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
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