Basics of Business Reorganization in Bankruptcy

by Steven L. Schwarcz

In this article, Steven Schwarcz offers an overview of Chapter 11 bankruptcy. In addition to beginning a Chapter 11 case, he also discusses administration of these cases and the plan of reorganization that a debtor must consider.

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Many of my clients, both domestic and international, view bankruptcy as a black box. A company goes into bankruptcy, and, perhaps, some years later emerges in a reorganized form. Some unfortunate companies, not possessing the proper talisman, never emerge at all from the black box. This article is an attempt to separate fact from myth by explaining the overall principles of a business reorganization in bankruptcy.

INTRODUCTION

In the U.S., business bankruptcy is generally governed by a federal legal code and can take the form of either a Chapter 7 case or a Chapter 11 case. A Chapter 7 case ordinarily results in liquidation of the company and, for that reason, is not very interesting. Most major companies do not liquidate in bankruptcy. Indeed, a company that is forced into a Chapter 7 case has the absolute legal right to convert the case to a Chapter 11.1

A Chapter 11 case is the basis of business reorganization in bankruptcy. Once a Chapter 11 case begins, the company's creditors will organize, under the supervision of a federal

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1 11 U.S.C. § 706(a). All section citations are to Title 11 of the United States Code, which constitutes the Federal Bankruptcy Code.
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The company that is the subject of a Chapter 11 case is referred to as the debtor. The creditors' committee and the debtor negotiate the major actions that the debtor must take to reduce operating costs, sell unnecessary assets where appropriate, and eventually compromise on a plan (called a plan of reorganization) by which the debtor is reorganized as a viable business corporation that no longer needs the protection of the bankruptcy laws.

The plan of reorganization also can restructure the amount, nature, and maturities of claims against the debtor and provide for the orderly payment of these restructured claims. Chapter 11, therefore, can affect the entire nature of a debtor and its relationship with creditors.

Every debtor and its relationship with creditors is unique. For that reason, the laws of Chapter 11 neither mandate that every plan or reorganization be the same or even similar nor that the steps taken to reach a plan of reorganization be the same. The essence of Chapter 11 is a consensus process through which the debtor and its creditors, represented for administrative convenience by the creditors' committee, negotiate and compromise their way along the path to reorganization.

It would, of course, be more efficient if, instead of negotiation, the debtor (or, alternatively, the creditors) alone made the decisions at each step. However, to permit that would lose sight of the two primary, but conflicting, goals of bankruptcy. On the one hand, bankruptcy recognizes that assets of the debtor should be distributed for the benefit of creditors. On the other hand, it also recognizes that the debtor should be given a good faith opportunity to reorganize its business. The Chapter 11 process described above is an attempt to recognize and give effect to both of these important but sometimes conflicting goals.

BEGINNING A CHAPTER 11 CASE

A company having significant financial difficulties, especially cash flow problems, might consider filing a petition for Chapter 11 to obtain the protections that the law gives to debtors. The stigma associated with bankruptcy has lessened to some degree, particularly since large and relatively viable companies, such as Manville Corporation, LTV Corporation, Texaco Inc., and Continental Air Lines, have used Chapter 11 as a way of attempting to restructure their debts.

Also, many business people mistakenly do not think of Chapter 11 as involving bankruptcy. A company may also be forced by its creditors into Chapter 11 if certain legal standards are violated, such as the company's generally not paying its debts as they come due.

Often, the company and its creditors do not think through all of the consequences of filing for Chapter 11. The most immediate and obvious consequence for creditors is that all rights of creditors to take actions to collect debts or foreclose on collateral are immediately and automatically suspended, or stayed. This is one of the most far-reaching provisions of bankruptcy law and is intended to give the debtor an opportunity to rehabilitate itself. The stay remains in effect throughout the bankruptcy case unless the court, after a hearing, lifts it for a particular creditor because that creditor has satisfied specific legal standards applicable to lifting the stay. Lifting the automatic stay does not often occur.

Creditors' Committee

As already mentioned, one important consequence of a Chapter 11 case is that the debtor and the debtor's relationship with its creditors and other third parties will become subject to the supervision of a bankruptcy judge and a bankruptcy trustee. One of the most important actions of the trustee is to appoint a creditors' committee. The law specifies ordinarily that the creditors holding the seven largest claims, if they are willing to serve, are appointed to a committee, but in practice, the trustee will try to make the committee representative of the claims in the bankruptcy case. In major bankruptcies, it is not uncommon to see committees with as many as a dozen or more members. Typically, representatives of banks, insurance company lenders, and trade creditors will dominate the committee. Often trustees for publicly issued debt securities (especially indenture trustees) will request appointment to a creditors' committee to fulfill what they perceive as their legal obligation to act as a prudent man in times of default under the public debt securities.

Creditors' Clash

Appointment of the creditors' committee is one of the first occasions for a clash of interests. However, this time the clash is not between the debtor and its creditors but among the creditors. Often institutional creditors, such as banks and insurance companies, want to recover their claims as quickly as feasible. Because there is a time value to money, a small face-value recovery obtained this year may be more valuable to an institutional creditor than a larger face-value recovery obtained next year. The institutional creditors, therefore, are likely to seek ways to obtain a quick recovery, and these ways might include attempts to liquidate the debtor. Trade creditors, on the other hand, may have more of an interest in preserving the debtor as a viable business entity, especially if the debtor is one of the trade creditors' important customers or suppliers. Therefore, tension is created at the outset as to who—institutional or trade creditors—will dominate the creditors' committee.

There are Chapter 11 cases in which a single creditors' committee is insufficient to represent adequately the inter-
Management During Chapter 11

While in Chapter 11, the debtor ordinarily will have the same management as before bankruptcy. There is no requirement of law that pre-bankruptcy management must resign, although officers and directors closely associated with the debtor prior to bankruptcy and whose credibility has been impaired by the bankruptcy may choose to resign or may be forced out by creditor pressure. Sometimes in major cases, the debtor’s board of directors will replace top management with one or more individuals who have particular experience and skill in turning around troubled companies.

In certain cases in which there has been fraud or gross mismanagement, the court will consider arguments, if advanced by creditors, for the appointment of a trustee-in-bankruptcy, who would manage the debtor in lieu of its normal officers and directors. In practice, however, bankruptcy courts are reluctant to appoint trustees-in-bankruptcy except in extreme cases, perhaps because they are reluctant to substitute court-appointed experts in place of businessmen who know the debtor and its business.

When a trustee-in-bankruptcy is not appointed, the court may (and in large case probably will) appoint an examiner. The role of the examiner is not clearly defined in the Bankruptcy Code. Because of early abuses of the examiner role, it has become customary in large cases for the creditors to select by consensus, at the outset of the case, a prominent lawyer of unquestioned character who will act as examiner according to a narrowly defined charter of responsibilities prepared by creditors and approved by the court. These responsibilities usually focus on the investigation of fraudulent acts of management and third parties (for example, accountants) and the possibility of recovery from these persons for the benefit of the debtor’s estate. In general, through, the role of the examiner is in the process of being established on a case-by-case basis.

Filing Under Chapters

Obtaining New Financing

The Bankruptcy Code grants far-reaching powers to a debtor in Chapter 11 to enable it to raise new financing. The court may grant the new lender a special priority on its claim for repayment, ahead of the claims of other creditors not having collateral. If that is insufficient to attract potential new lenders, the court may also order that a lien be created on existing or after-acquired property of the debtor to secure repayment of the new loan. At times, the debtor needs the new financing but has no unencumbered assets on which a lien can be granted of sufficient value to entice a potential lender. In such extraordinary circumstances, the court may order that a new lender receive a first lien on property that is already subject to a lien created prior to bankruptcy.

Sometimes new financing is provided by an existing lender. As an inducement to the existing lender to make new advances, the debtor may offer to secure both the lender’s exist-
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ing claim (to the extent it is not already secured) and its claim for the new advances. Such an arrangement, known as cross-collateralization, is subject to court approval, which may be granted after notice and a hearing.

A debtor’s attempt to obtain new financing during a Chapter 11 case can raise many problems. Of particular interest is the tension between a debtor that wants new financing to purchase inventory to manufacture new products and a creditor who would prefer that no new claims, equal to or ahead of his own claim, be created by the incurring of the new financing. The creditor probably will not be sympathetic to the desire of a debtor to manufacture more inventory that may not be readily salable.

Making Money

Once the debtor has obtained needed financing and reestablished lines of trade credit, it can begin to turn its attention to the job of making money. Because a company known to be in Chapter 11 is unlikely, at least at the outset of the case, to be in a position to expand its markets, the usual focus is on reducing operating costs and selling unneeded assets.

The debtor will often retain accountants to help identify areas where costs can be reduced and to institute controls on the incurrence of future costs. For example, a particular manufacturing plant might, under close scrutiny, be found to be obsolescent; the debtor could save significant costs by shutting it down and terminating the employees.

Investment bankers may also be retained, especially in large cases, to identify major assets, divisions, and subsidiaries to sell. An example might be the sale of a division with an unrelated product. The debtor might not have the management skills to make the division profitable, but the product itself may have considerable commercial value. The division could be sold to a company having expertise in that product. The happy result is that the debtor would receive value for selling a division which previously was a cash drain, and the division would be managed by a new company having the expertise to render it profitable.

Third-Party Contracts

The ultimate goal of the debtor and its creditors is to reduce costs and gain effective control of the business sufficiently so that it becomes feasible to propose a plan for financial reorganization. Achieving this goal almost certainly will take months, and in a large case, could take years. During that time, third parties having contracts with the debtor may want to enforce these contracts, but they are prevented from doing so by the automatic stay, already discussed above. There is a procedure by which parties to contracts can attempt to compel the debtor to decide whether or not to accept, or assume, these contracts. In practice, however, a court is reluctant to compel the debtor to choose to assume or reject a contract prior to the plan of reorganization if the debtor has convincing arguments that it cannot properly make that decision before it thinks through the requirements of its plan of reorganization.

The debtor does, however, have the right under the Bankruptcy Code to reject a contract at any time if the debtor can show that continued performance is not in its business interests. If a contract is rejected, the debtor no longer must perform its obligations thereunder but will be liable for damages for breach of contract. However, the damage claim against the debtor will be a general unsecured claim and not be entitled to any special priorities in bankruptcy.

The debtor also has the right to affirm, or assume, a contract that it regards as advantageous, even if the contract, by its terms, terminates in case of bankruptcy. For example, assume the debtor has a contract with ABC Company to purchase widgets at $5 per widget. The price of widgets has increased to $7 per widget. The debtor could, if it cures the defaults under this contract (other than defaults generally relating to bankruptcy, insolvency, or financial condition) and provides adequate assurance of future performance, assume this contract and thereby obtain the benefit of the $2 per widget favorable price differential. This is a powerful right of the debtor to preserve the benefit of long-term advantageous contracts. The debtor even has the right to assign or sell these contracts to third parties.

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PLAN OF REORGANIZATION

Once the debtor has managed to control its costs and stabilize its business operations, it will begin considering how to structure its plan of reorganization. The chief purpose of the plan is to restate the contractual relationship between the debtor and its creditors in a manner that will allow the debtor to operate as a viable company outside of the protections of Chapter 11.

The debtor has the exclusive right to propose a plan of reorganization for the first 120 days after the bankruptcy commences. In large cases, this is rarely enough time, and the court may extend this period of exclusivity for sufficient periods to allow the debtor time to control costs and stabilize the business. The debtor has a period of exclusivity because it was recognized that it would be awkward to allow creditors the right to file separate plans, without first giving the debtor the right to file its own plan.

In a typical plan of reorganization, each of the claims against the debtor incurred prior to bankruptcy would be classified according to the Bankruptcy Code. Holders of general unsecured claims might, for example, receive

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11 § 365(a). This right only extends to the rejection of executory contracts; that is, contracts where material performance is still due on both sides.
12 § 365(b).
13 § 1123(b).
14 § 365(c).
15 One could imagine that a creditor’s plan would focus on repayment in full of claims, without sufficient regard for rehabilitation of the debtor.
payment of their claims through a combination of cash and long-term debt instruments or equity securities. Holders of claims subordinated to general unsecured claims would probably receive a significantly lesser value per dollar of claim. Claims of other classifications would be expected to receive more or less, depending on the relative ranking of the claims in a bankruptcy liquidation and, therefore, the relative negotiating strength of creditors holding these claims.

Key to Successful Plan
The key to a successful plan of reorganization is that it be consensual. That means, in practice, that each class of claims must receive enough value for its claims to persuade the class to vote affirmatively for the plan. The Bankruptcy Code contains certain inducements to consensus. Perhaps the most important and well known is the so-called cramdown provision. In essence, this provision maintains the following:

1. A junior class (for example, a class of subordinated claims or a class of equity interests) will be legally deemed to have accepted a plan of reorganization which provides that no class senior to it receives, in the plan, value worth more than 100% of the claims represented by such senior class.

2. No class junior to it receives any value on account of its claims or interests.

Cramdown Principle
Consider a class of general unsecured claimants receiving cash and debt securities valued at 100% of the general unsecured claims. Those claimants may be able to cram down a plan of reorganization over the objection of a class of subordinated public debentures as long as no class of claims or interests junior to the subordinated public debentures receives value under the plan of reorganization.

Although in principle cramdown sounds like a powerful tool, in practice, it would require a hearing to value the debtor's assets and the benefits received by the senior claimants to ensure that no senior claimants receive more than 100% of their claims. A valuation hearing of this sort can be very expensive and time consuming and will almost certainly result in prolonged litigation as to whether the valuation was properly done. Therefore, cramdown is most important as a threat to induce junior classes of creditors to accept a plan of reorganization proposed by the debtor or by senior creditors, since there is a theoretical risk that the junior class could receive much less in a cramdown. On the other hand, the difficulty caused by the valuation hearing is also

CONCLUSION
There are many other important considerations in a Chapter 11 case not mentioned in this overview. For example, one of the most valuable assets of a bankrupt company frequently is its federal income tax attributes. Most bankrupt companies operate at a loss for several years prior to bankruptcy and, therefore, typically will have significant carryovers to future tax years for net operating and capital losses and investment tax credits. The manner in which the bankrupt company is restructured should be tailored to maximize and preserve these carryovers.