<u>Bankruptcy and a Fresh Start: Stigma on Failure and Legal Consequences of Bankruptcy</u>

United States Report
Prepared by White & Case LLP

Title 1. Introduction

The Constitution of the United States creates a Federal structure, with residual power in the States and certain specific powers allocated to the Federal government. Among the Federal powers is the power to establish uniform bankruptcy laws for all of the States, as well as territories. The law governing bankruptcy in the United States is the Bankruptcy Code.

The bankruptcy laws of the United States have evolved since the adoption of the Constitution pursuant to legislation that is periodically enacted and amended by the United States Congress. Congress has exclusive responsibility for drafting the Federal bankruptcy law. The first permanent bankruptcy legislation was enacted under the Bankruptcy Act of 1898 and formed the basis for modern United States bankruptcy law. This act was comprehensively amended by Congress through the Act of June 22, 1938, commonly known as the Chandler Act. This Act created the basis of reorganization of companies in the United States and significantly reduced the stigma of bankruptcy by permitting a company to restructure its assets and liabilities as a going concern rather than liquidating.

In 1978, Congress enacted the Bankruptcy Reform Act of 1978, known as the "Bankruptcy Code," which established a comprehensive system for both individual and business insolvencies. The Bankruptcy Code is administered by Federal judges, presiding over specialized tribunals called "Bankruptcy Courts," that are located throughout the United States and that, for the most part, have jurisdiction that is national in scope. As discussed below, the States possess legislation that provides for the altering of debtor/creditor relationships, including assignment for the benefit of creditors and compositions.

Filing under the Bankruptcy Code is not limited to domiciliaries, "merchants" or "entities with property," and is open to individuals and most forms of business entity. The principal exclusions are banks, insurance companies and a few other regulated enterprises that are liquidated for the most part by Federal or State regulators. The key prerequisite to a filing in the United States is that there is property or a property interest in the United States to be protected.

The Bankruptcy Code is structured in several chapters. There are a set of provisions, set forth in chapter 1 (entitled "General Provisions"), chapter 3 (entitled "Case Administration") and chapter 5 (entitled "Creditors, the Debtor and the Estate") of the Bankruptcy Code, that apply in all bankruptcy cases. The basic rules apply whether the debtor is in liquidation or restructuring proceedings: in either case the entity is considered to be in "bankruptcy." These provisions include an immediate and automatic stay prohibiting all adverse creditor activity upon the filing of the petition, the creation of bankruptcy "estates" (which holds all of the debtor's assets and interests), the requirement that most creditors file claims against the estate, and the power of the estate administrator to bring certain avoidance actions to augment the estate.

Chapter 7 (entitled "Liquidation") provides procedures for the liquidation of a business enterprise or, in the case of an individual, the application of the individual's non-exempt pre-petition property to his or her debts, with the individual then discharged from all pre-bankruptcy liabilities (except for a limited category of non-dischargeable debts such as taxes, alimony and child support, student loans and claims based on certain fraudulent or tortious conduct). Chapter 7 liquidation procedures are similar to those in most other legal systems: a trustee is appointed, and his principal tasks are the liquidation of debtor's assets, the turnover of collateral to secured creditors, the distribution of assets to other creditors in order of priority, and the pursuit of any estate claims. An extensive discussion of chapter 7 is not within the purview of this analysis.

In addition, the Bankruptcy Code has chapter 9 (entitled "Adjustment of Debts of a Municipality"), chapter 12 (entitled "Adjustment of Debts of a Family Farmer with Regular Annual Income") and chapter 13 (entitled "Adjustment of Debts of an Individual with Regular Income"). The chapters are not within the purview of this analysis.

Chapter 11 of the Bankruptcy Code (entitled "Reorganization") is the cornerstone of sophisticated bankruptcy practice in the United States and sets forth a structure for the reorganization or rehabilitation of either a corporate or (rarely) an individual debtor. Chapter 11 of the Bankruptcy Code provides a financially troubled business with an opportunity to restructure its finances to enable the continuation of its operations. To promote this goal, chapter 11 enables a debtor to remain in control of its assets and business (as a "debtor in possession") while negotiating a restructuring of its affairs. The debtor benefits from an orderly process for negotiating with its creditors and equity securityholders in a central forum with uniform rules and procedures for the administration of a chapter 11 case.

In enacting the Bankruptcy Code, Congress recognized the necessity to enable a debtor to achieve a fresh start or to reorganize a business. Congress has also recognized that the continuation of the operations of the debtor as a viable business, rather than the debtor's liquidation, benefits the national economy through the preservation of employment and continued production of goods and services. Congress also recognized the need to permit a debtor to sell its assets and to provide protections to these entities purchasing such assets. At the same time, however, Congress recognized that the interests of creditors also must be protected against unequal or unfair treatment. Thus, the bankruptcy laws as enacted by Congress contemplate a balancing of the interests of debtors, creditors, and society as a whole.

Chapter 11 is based on several policy determinations. The first is that it is more advantageous to those with a stake in the enterprise – including creditors, shareholders and employees – for the enterprise to survive as a going concern than to be liquidated, and that the debtor should be given wide scope to effect a reorganization. The second is that companies, like individuals, should have a "second chance" to make good after a discharge of their debts in bankruptcy. The third is that the best qualified individuals to reorganize the company are those who managed it prior to bankruptcy; the drafters of the Bankruptcy Code law thought that even if there was some mismanagement that contributed to the bankruptcy, current management was preferable to a bureaucrat or an outside party who would not be familiar with the business and its opportunities. Accordingly, chapter 11 initially leaves management in control of the debtor and provides that a trustee may be appointed only in extreme circumstances – for example, where there is a finding of fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management. Management continues to operate the debtor after the commencement of a chapter 11 case, subject to the supervision of the Bankruptcy Court (although the Court has no day-to-day connection with the administration of the debtor) and subject to the oversight of an active creditors committee.

Chapter 11 enables the parties in a chapter 11 proceeding the opportunity to “negotiate” a plan designed to maximize distributions to creditors, keep the business operating, and give shareholders at least some chance to recoup their investment. All interested parties, including management, representatives of the creditors and shareholders, labor representatives, and others with a stake in the enterprise, try to strike a deal, with no one party in interest having the ability to force the court to resolve matters in its favor. While the debtor (through its management) may dominate negotiation of a plan during the debtor's “exclusive” period to file a plan, the debtor owes a fiduciary duty to its creditors to maximize operations and recoveries for the benefit of all of its stakeholders. The emphasis on a negotiated settlement without any firm deadlines has meant that a chapter 11 case can often be lengthy and expensive process. However, with increasing frequency, and in cases where secured creditors dominate a debtor’s creditor constituency, chapter 11 is also used a means by secured creditors to liquidate the debtor’s business in a matter of months.

As a result of the structure of chapter 11, much of the stigma that had previously accompanied a bankruptcy filing has long faded away. With the advent of the so-called “mega cases,” or chapter 11 cases with debtors holding billions of dollars in assets and liabilities, chapter 11 has become a staple for both sophisticated debtors and creditors to restructure complex debt/equity structures. Bankruptcy is now a viable alternative for even the most respected companies in the United States whose operations have been challenged by shifts in the economy or, in the cases of companies that produced silicone breast implants or asbestos products, mass tort lawsuits. Bankruptcy has been accepted in the marketplace to a large extent, and even debtors that depend on servicing the public, such as airlines and retailers, have found it possible to stay successfully in business after a chapter 11 filing. Chapter 11 has also been viewed as a useful alternative for a company that otherwise finds it impossible to deal with particular problems, such as those arising from multiple product liability lawsuits and unanticipated judgments.

Chapter 11 has been criticized on several fronts. First, chapter 11 is used by many smaller companies that realistically do not have much chance to reorganize. These companies file for chapter 11 protection and then, when they use up all their available funds, convert to a chapter 7 liquidation. Second, chapter 11 cases take a great deal of time and money, including professional advisor fees, to work through the process. There is, accordingly, a strong effort by companies to “work out” their problems outside of chapter 11 by an agreement with their largest creditors. However, these negotiations are held against the backdrop of chapter 11 procedures that are viewed to be generally friendly to management and debtors. Chapter 11 has not forestalled efforts to work out problems outside of bankruptcy, but its procedures have, of course, influenced the results of those out-of-court processes, including a company's ability to use bankruptcy as a sword against creditors.

Title 2. Definitions and terminology

The following terminology applies to the Bankruptcy Code, "out of court" restructuring/liquidation and state law insolvency proceedings:[1]

"Assignment for the Benefit of Creditors" means a voluntary transfer of assets by the debtor to another person in trust to liquidate the assets and distribute the proceeds to creditors of the debtor/transferor.

"Bankruptcy Court" means the courts established by Congress to hear cases under title 11 of the United States Code.

"Chapter 11 trustee" means a disinterested person appointed by the Bankruptcy Court for the purpose of conducting the debtor's business affairs in the event cause is demonstrated, including fraud, dishonesty, incompetence or gross mismanagement of the debtor's estate.

"Composition" means a contract between a debtor and two or more creditors in which the creditors agree to take a specified partial payment in full satisfaction of their claims.

"Creditor" means an entity that has a claim against a debtor that arose at the time of or before the order for relief concerning the debtor. 11 U.S.C. § 101(10)

"Creditors' Committee" means a committee of creditors holding the largest unsecured claims against the debtor appointed by the United States trustee.

"Debt" means liability on a claim. 11 U.S.C. § 101(11)

"Debtor" means person or municipality concerning which a case under this title has been commenced. 11 U.S.C. § 101(13)

"Debtor in possession" means the debtor under chapter 11 of the Bankruptcy Code responsible for the operation of the debtor's business affairs. 11 U.S.C. § 1101(1)

"Equity security holder" means holder of an equity security of the debtor. 11 U.S.C. § 101(17)

"Forbearance agreements" means an agreement between a distressed company and its lenders during which the lender agrees to forbear from enforcing its remedies under its credit agreements.

"Foreclosure" means a state law proceeding pursuant to which a creditor obtains a judgment in satisfaction of a claim against the creditor and is then permitted to seek to gain judicial control of the creditors' assets.

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1 The citations following the definition are to the Bankruptcy Code.

"Foreign proceeding" means a proceeding, whether judicial or administrative and whether or not under bankruptcy law, in a foreign country in which the debtor's domicile, residence, principal place of business, or principal assets were located at the commencement of such proceeding, for the purpose of liquidating an estate, adjusting debts by composition, extension, or discharge, or effecting a reorganization. 11 U.S.C. § 101(23)

"Foreign representative" means duly selected trustee, administrator, or other representative of an estate in a foreign proceeding. 11 U.S.C. § 101(24)

"Governmental unit" means United States; State; Commonwealth; District; Territory; municipality; foreign state; department, agency, or instrumentality of the United States (but not a United States trustee while serving as a trustee in a case under this title), a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government. 11 U.S.C. § 101(27)

"Insider" includes (A) if the debtor is an individual – (i) relative of the debtor or of a general partner of the debtor; (ii) partnership in which the debtor is a general partner; (iii) general partner of the debtor; or (iv) corporation of which the debtor is a director, officer, or person in control; (B) if the debtor is a corporation – (i) director of the debtor; (ii) officer of the debtor; (iii) person in control of the debtor; (iv) partnership in which the debtor is a general partner; (v) general partner of the debtor; or (vi) relative of a general partner, director, officer, or person in control of the debtor; (C) if the debtor is a partnership – (i) general partner in the debtor; (ii) relative of a general partner in, general partner of, or person in control of the debtor; (iii) partnership in which the debtor is a general partner; (iv) general partner of the debtor; or (v) person in control of the debtor; (D) if the debtor is a municipality, elected official of the debtor or relative of an elected official of the debtor; (E) affiliate, or insider of an affiliate as if such affiliate were the debtor; and (F) managing agent of the debtor. 11 U.S.C. § 101(31)

"Insolvent" means – (A) with reference to an entity other than a partnership and a municipality, financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of – (i) property transferred, concealed, or removed with intent to hinder, delay, or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate; (B) with reference to a partnership, financial condition such that the sum of such partnership's debts is greater than the aggregate of, at a fair valuation – (i) all of such partnership's property, exclusive of property of the kind specified in subparagraph (A)(i) of this paragraph; and (ii) the sum of the excess of the value of each general partner's nonpartnership property, exclusive of property of the kind specified in subparagraph (A) of this paragraph, over such partner's nonpartnership debts; and (C) with reference to a municipality, financial condition such that the municipality is – (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or (ii) unable to pay its debts as they become due. 11 U.S.C. § 101(32)

"Person" includes individual, partnership, and corporation, but generally does not include governmental unit. 11 U.S.C. § 101(a)

"Petition" means petition filed with the clerk of the Bankruptcy Court commencing a case under this title. 11 U.S.C. § 101(42)

"Workout" means an out-of-court process through which a financially distressed company and its significant creditors reach an agreement for adjusting the company's obligations.

"United States trustee" means the person appointed by the Attorney General for the United States for the purpose of, among other things, monitoring and supervising the administration of cases under chapters 7, 11, 12, or 13 of the Bankruptcy Code. 28 U.S.C. § 581

Title 3. Warning Lights and Prevention of Insolvency

The United States capital markets provide a variety of procedures, both formal and informal, that monitor and gauge the financial health of companies and provide a substantial amount of empirical data to forecast a company's financial health and the potential for insolvency. In most cases, the company itself telegraphs a series of warning signs, either through publicly filed statements with the United States Securities and Exchange Commission (the "SEC") which regulates companies with public debt, or press releases. In addition, large and mid-size companies, both private and public, are routinely evaluated in financial reports produced by investment banking, financial institutions, or brokerage houses. Since the late 1980s, when large bankruptcy filings in the United States surged to unparalled levels, a market has developed where investment bankers and financial institutions specifically monitor companies for the purpose of investing and trading in their distressed debt and claims in the hopes of profiting from an upturn in the companies' financial health. Beyond the publicly available information on the company's business operations, other signs of financial distress include the lowering of a company's debt ratings by financial rating services such as Standard & Poor's and Moody's Investor Service. Generally, the warning signs of financial distress are signaled to creditors well before a financial collapse and insolvency occurs, thus permitting the company and its principal creditors to engage in the workout process in an effort to avoid a chapter 11 filing. Accordingly, the commencement of a chapter 11 case is seldom a complete surprise. For example, the recent chapter 11 filing by Kmart, a large United States retailer with over 2,000 stores, was forecast several weeks in advance. However, as exhibited by the recently filed Enron chapter 11 cases pending in the United States Bankruptcy Court for the Southern District of New York, the system is far from perfect. The Enron filing stunned many financial analysts. Other examples of enterprises that tumbled into insolvency with little warning are Long Term Capital Management, whose financial collapse occurred several years ago and was resolved outside of the Bankruptcy Code, and the Global Crossing chapter 11 cases which are also pending in the United States Bankruptcy Court for the Southern District of New York.

Once the warning signals begin to emerge, the company and its creditor constituencies may attempt to mitigate the impact of the negative signals on the operations of the company in order to avoid the downward fall of the company's operations and its values, including its equity value. If the parties are properly positioned, the distressed company may be able to avoid bankruptcy. As discussed in Title 4, the methodology to avoid bankruptcy includes out of court restructurings in the form of workouts and compositions or other voluntary arrangements for the restructuring of the company's debt obligations.

Title 4. Legal Possibilities To Continue Economic Activities Outside of Bankruptcy

The insolvency of a business enterprise may result in a restructuring or liquidation of the enterprise occurring outside of the provisions of the Bankruptcy Code. These non-judicial procedures may result in the distressed company's ability to avoid a bankruptcy filing.

A financially distressed company in the zone of insolvency generally has a diverse body of creditors with varying expectations of the company. Before the company (which has presumably defaulted or will soon default on its material debt obligations) commences a bankruptcy case, which can be a costly and disruptive process, the company may conclude that the consensual restructuring of its debt obligations can be negotiated first with its significant creditors outside of bankruptcy. A consensual restructuring outside of chapter 11 is known as a "workout," which is a nonjudicial process through which a company and its significant creditors attempt to reach an agreement to restructure and adjust the company's debt obligations, including the adjustment of payment schedules, the maturity date of the debt obligations and material financial covenants, and the issuance of new and/or additional debt instruments (for example, convertible debt obligations and preferred equity). In addition, the ultimate restructuring may also impose restrictions on the company's ability to incur additional debt, issue new securities, change corporate governance provisions, and, in some cases, commence bankruptcy proceedings. The company's creditors who participate in the workout depend largely on the company's financial problems but, at a minimum, include significant creditors such as secured lenders, subordinated bondholders and, in some cases, major vendors and suppliers, and equity security holders.

In order to effectively implement a workout, the restructuring of the company's debt must be consensual. A deal with the company's secured lenders may not satisfy the bondholders who, in turn, may continue to negotiate in an effort to obtain a more favorable settlement, coupled with the threat of filing an involuntary bankruptcy case against the company, as discussed below. Conversely, if the company has adequate time to prepare, the company may itself threaten the commencement of a chapter 11 case in order to exact a compromise from its creditors. Indeed, a factor that strongly influences the extent to which creditors are willing to compromise on a position is the chapter 11 process itself. Because a workout is the last step before bankruptcy, the negotiating parties must assess the risks and benefits of whether a quick consensual workout is more beneficial than a drawn-out bankruptcy case.

As part of the workout process, the company's substantial creditors, in particular its lenders, first negotiate a forbearance or standstill agreement that temporarily freezes the company's debt obligations. The negotiation of the forbearance agreement provides the company's significant creditors the opportunity to exact concessions from the company in exchange for the creditors not exercising their available remedies. Typically, forbearance agreements can provide for the accrual of default interest, the collection of proceeds from accounts receivable directly into a lender's "lockbox" account, tighter reporting requirements, the immediate implementation of cost-savings measures, access to the company's books and records by the creditors' restructuring professionals, and the payment of the creditors' professional's fees during the restructuring process. In some instances, the forbearance agreement may provide for a waiver of the protections of the automatic stay in favor of the creditors.[2]

The formal restructuring is implemented by "compositions" – which today are often called "workouts." A composition is a voluntary agreement between a debtor and some or all of its creditors providing for the restructuring of the obligations of the debtor. Under the United States Constitution, States are barred from enacting laws providing for the impairment of contractual obligations. Accordingly, non-bankruptcy composition agreements are binding only upon consenting creditors. Creditors may be induced to enter into a composition agreement by the threat or reality that they will receive a smaller return on their claims if they do not enter into the agreement, but the process rests ultimately on consent.

Typically, a composition agreement provides that the agreement will be effective between the debtor and consenting creditors only if the agreement is accepted by a certain percentage of creditors whose acceptance is solicited. For example, a composition agreement might provide that, upon acceptance by 95% (in dollar amount) of a certain class of creditors, creditors accepting the agreement will defer the maturity date of their obligations for a fixed period of time. In recent years it has become popular to use the Bankruptcy Code to force a composition acceptable to a majority of creditors on a recalcitrant minority – or a minority that cannot be easily located. Thus the debtor and major creditors may negotiate the terms of a composition, file it with the Bankruptcy Court as a "prepackaged plan," and attempt to get it confirmed within 30-60 days. Generally, a plan that meets certain criteria can be accepted by creditors holding claims that are two-thirds in amount and more than one-half in number of those that vote in each relevant creditor class. Through the Bankruptcy Code, these super-majorities may be able to agree to a "pre-packaged plan" and bind a majority.

An enterprise may enter into voluntary arrangements with its creditors other than compositions in an effort to restructure its obligations. Subject to Federal or State statutes requiring priority or equal treatment of specific classes of creditors in liquidation, an enterprise generally is free to operate or liquidate its assets without court supervision at any time and in any manner the enterprise chooses. (The State law procedure for liquidation of a corporation is called a dissolution and may require notice to all remaining creditors.) An insolvent (in the balance sheet sense) enterprise is prohibited by fraudulent conveyance laws (and, in the case of a

[2] For example, in the event a company ultimately commences a case under chapter 11, the forbearance agreement may include a provision that the debtor will not challenge a motion for relief from the automatic stay brought by a participating creditor in the chapter 11 proceeding. The ability to enforce such a provision is problematic. The emerging trend under case law is to permit the limited enforcement of stay provision waivers. Some courts have held that a stay provision waiver will preclude the debtor from challenging a motion for stay relief brought by a party to the forbearance agreement. Other courts have indicated that the existence of such a provision in a bona fide workout situation will be analyzed as a significant factor in the court's analysis of what constitutes cause for granting relief from the automatic stay. A number of courts continue to hold that stay provision waivers are *per se* unenforceable. Therefore, regardless of the forbearance agreement, a creditor may find itself in a bankruptcy court forum that does not enforce such provisions.

corporation, by corporate law) from distributing liquidation proceeds to its shareholders or other owners.

In certain circumstances, the owners of an enterprise or creditors of the enterprise may petition a court for the appointment of a receiver to take possession of and to liquidate the assets of the enterprise for the benefit of creditors or shareholders. A receiver may also be appointed at the request of the owners of the enterprise when a dispute among them prevents effective management of the enterprise. Receivers are most commonly appointed when management of the enterprise has engaged in fraud or gross mismanagement.

A receiver operates as an officer of the court and takes instructions from the court on how to proceed with the liquidation of the enterprise. Subject to the rights of secured creditors, proceeds of the liquidation of an enterprise by a receiver are applied first to priority claims, including the receiver's compensation and other expenses of the receivership, then to the claims of general unsecured creditors, and, if anything is left, then to the interests of the owners of the enterprise. In some cases, a receivership may be a less expensive alternative to a formal bankruptcy case. A receiver, however, does not have the same powers to avoid fraudulent or preferential transactions as are granted to a trustee in bankruptcy or a debtor in possession under the Bankruptcy Code. Moreover, he is subject to being displaced at any time by a bankruptcy filing, as a bankruptcy trustee (or the debtor in chapter 11 if there is no trustee) automatically displaces a receiver.

In a few States, assignment for the benefit of creditors is still employed to liquidate the assets of an insolvent enterprise. In an assignment for the benefit of creditors, the debtor assigns some or all of its assets to an assignee who liquidates the assets for the benefit of creditors of the debtor. The assignee is compensated pursuant to the contractual arrangement between the assignor and the assignee. As in the case of a receivership, the proceeds of unencumbered assets are used to satisfy priority claims, including the assignee's own claims for compensation and expenses, then to pay non-priority unsecured claims and then, if anything is left, to make a distribution to the owners of the enterprise.

Assignments for the benefit of creditors do not require court supervision and therefore may be substantially less expensive and quicker than either a receivership or a formal bankruptcy proceeding. However, because the provisions of the Bankruptcy Code (particularly chapter 11) are so friendly to debtors and so easy to initiate, and because only the Bankruptcy Code can be used where creditors are located in more than one State (unless all otherwise agree), State procedures have withered and are rarely utilized today, and the Federal Bankruptcy Code is almost invariably invoked, when a judicial procedure becomes necessary – or is perceived as necessary. In addition, the Bankruptcy Code provides significant protections to parties purchasing assets, including the sale free and clear of liens, claims, encumbrances and interests.

Title 5. Legal Consequences of Bankruptcy and Possibilities for a Fresh Start

Chapter 5.1. Chapter 11 of the Bankruptcy Code

§5.1.1. Commencement of Proceedings

Although the stigma has diminished substantially, the decision to commence a chapter 11 case is never easy. Once in chapter 11, the debtor loses its accustomed autonomy – it has to recognize a new set of duties and accountability to its creditors, the United States trustee and most importantly, the Bankruptcy Court. The Bankruptcy Code gives creditors, who may be vendors, lenders, high-yield investors, landlords, customers, employee groups, trader and debtor claims or even competitors, oversight and sometimes power over the debtor's operations. Since the boom in bankruptcies in the late 80s and early 90s and now the current boom in bankruptcies, the increase in chapter 11 filings over the past decade has given rise to a great deal of sophistication and activism on the part of such creditors, who often demand significant participation in the debtor's key strategic decisions regarding business operations, restructuring and rehabilitation. In addition, the commencement of a chapter 11 case is often accompanied by the appointment of a committee of general unsecured creditors, and in some cases, the appointment of an equity holders committee. In some of the very large cases, it is not unusual to have in addition to the general unsecured creditors committee, a committee of bondholders.

The commencement of a chapter 11 case is a shock to any organization. Outside of a bankruptcy, the company was accustomed to operating its business with accountability only to its stockholders and confidentiality of much of its business records and financial data. In chapter 11, by contrast, although the company is authorized to continue to operate its business, it is transformed by the Bankruptcy Code into a "debtor in possession," subject to court and creditor oversight and its property is deemed to be an estate for the benefit of all parties in interest. While the company enjoys the immediate benefit of the automatic stay which bars creditors from commencing or continuing actions against the debtor or its property, the debtor becomes subject to the jurisdiction of the Bankruptcy Court, the constraints of the Bankruptcy Code, the operating guidelines imposed by the office of the United States trustee and the scrutiny of its creditors. The company is thus free to concentrate on stabilizing its business operations and ultimately pursue a reorganization, or in some cases, a liquidation, without the fear of those creditors racing to the courthouse in foreclosure actions and other type litigation. However, the company must immediately begin to answer the tough questions posed by its creditors, stakeholders, many of whom are seasoned and sophistication veterans of bankruptcy, regarding its financial condition and its chances for a successful reorganization. In addition, there are the costs of professionals incurred by the debtor's estate: the debtor and the creditors' committee typically employ a number of professionals, including their respective attorneys, accountants, investment bankers and other experts, all of whom are paid by the debtor's estate. This is the price paid by a debtor seeking a fresh start rather than immediate liquidation.

a. <u>Voluntary Proceedings</u>

When forbearance agreements have terminated and workout efforts have failed to produce satisfactory results for creditors, either as a result of lack of confidence in the company's future by its significant creditors or as a consequence of unacceptable settlement proposals by the company, the company may determine to "voluntarily" commence a case under chapter 11 of the

Bankruptcy Code. A reorganization case under chapter 11 is ordinarily commenced by the debtors filing a voluntary petition with the clerk of the Bankruptcy Court. A petition is a short and concise document setting forth elementary information about the debtor. The petition is accompanied by a resolution of the board of directors of a corporation, or the general partners of a partnership, authorizing the filing. At the time of or shortly after filing a petition, the debtor files a schedule of creditors. The court thereafter notifies the scheduled creditors of the commencement of the case, of the date set for a meeting of creditors and of deadlines that may arise from the commencement of the case or the meeting of creditors. The debtor may, but is not obligated to, notify creditors of the commencement of the case. As the commencement of a case often is triggered by the actions of a particular creditor or group of creditors, the debtor usually will notify such creditor or group of creditors of the commencement of the case so as to advise them of the automatic stay of creditor action which arises upon the filing of a petition.

The filing of a voluntary petition is deemed to constitute the entry of an order for relief. Although a chapter 11 proceeding bears certain resemblance to a suspension of payments proceeding in other systems, it is a provision of the bankruptcy laws and, immediately upon the filing of a voluntary petition, the general provisions of the Bankruptcy Code come into effect. Among other things, an automatic stay instantly takes effect, prohibiting substantially all creditor action against the debtor or its assets, an estate in bankruptcy is created, the debtor's business and property become subject to the jurisdiction of the Bankruptcy Court, and the creditors are (at some point in the future) required to file proofs of claim.

Immediately after the filing of the chapter 11 petition, the Bankruptcy Court schedules “first day” hearings on a number of motions (or formal requests) for relief. These motions typically include a request for (i) postpetition financing and the use of cash collateral, (ii) payment of trust fund sales and use taxes, (iii) the continued use of existing bank accounts, cash management system and business forms, (iv) authority to pay critical trade vendors (notwithstanding the automatic stay), (v) a prohibition against utilities altering, refusing or discontinuing services, (vi) authority to pay prepetition wages, salary and other benefits and maintain health insurance and workers’ compensation programs and (vii) retention of professionals to prosecute the cases.

b. Involuntary Proceedings

The Bankruptcy Code permits petitioning creditors that meet certain threshold criteria to involuntarily force a debtor into bankruptcy proceedings. Outside of terminating a company’s operations, there is no greater threat to a company on the brink of insolvency than the threat of having the power to commence a bankruptcy case stripped from its control. In addition, the filing of an involuntary case signals third parties (including trade vendors and customers, as well as the company’s rank and file employees) that the company’s financial stability is in jeopardy. From the debtor’s view, control of the chapter 11 process is critically important in order to time a controlled, “soft landing” into chapter 11. A controlled chapter filing permits the company to choose the exact date it wishes to file, the venue of the chapter 11 case, stockpile cash, negotiate postpetition financing or the use of cash collateral, control the dissemination of publicity, and adequately alert and prepare its employees, vendors and suppliers of the bankruptcy filing. Accordingly, the threat of an involuntary case often brings the company back to the negotiation table in order to complete a restructuring satisfactory to the needs of the company’s significant creditors.

There is no requirement that a debtor voluntarily commencing a bankruptcy case be insolvent, be unable to pay its debts as they become due or meet any other financial standard. Creditors filing a contested involuntary petition must show that the debtor is generally not paying its debts as they become due in order to obtain the entry of an order for relief. In a typical case where a large company has 12 or more creditors, an involuntary bankruptcy case may be commenced by three or more creditors "each of which is either a holder of a claim against such person that is not contingent as to liability or the subject of a bona fide dispute, or an indenture trustee representing such a holder, if such claims aggregate at least $11,625 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims." A representative of a foreign estate is also authorized to file an involuntary petition.

The filing of an involuntary petition with the bankruptcy court by petitioning creditors does not automatically lead to the entry of an order for relief. The company has 20 days to answer or contest the involuntary petition or file its own voluntary petition. The period of time between the filing of the involuntary petition and the entry for an order for relief is known as the "gap period" during which the debtor continues its normal business operations. The Bankruptcy Code provides that to the extent that the bankruptcy court requires otherwise and until the entry of the order for relief, the gap debtor may continue to operate its business and can use, acquire or dispose of property as if the involuntary case had not been commenced. In the event the debtor fails to timely controvert the involuntary petition, the bankruptcy court may order the entry for relief against the debtor, thus commencing the chapter 11 case. If the debtor does timely controvert the involuntary petition, then the bankruptcy court will conduct a trial to determine the validity of the involuntary petition.

The filing of an involuntary petition is not without potential risk and cost to the petitioning creditor. The Bankruptcy Code provides that if an involuntary petition is dismissed by the court, then the petitioning creditors may be liable to the debtor for costs and, in some cases, punitive damages. The bankruptcy court has wide discretion in awarding costs, reasonable attorney's fees or punitive damages to the debtor and will look to factors, such as whether the petition was filed in bad faith. In addition, petitioning creditors may be required to post a bond to indemnify the debtor for any damages arising from the involuntary filing.

c. Cases Filed in Bad Faith

A creditor or other party in interest may challenge the good faith of the debtor in commencing or prosecuting a bankruptcy case. If the bankruptcy court finds that the debtor has commenced or is prosecuting the case for an improper purpose, such as the avoidance or deferral of payment on a claim which the debtor has the ability to satisfy without disruption of its business or operations, or that the debtor has commenced a reorganization case without any realistic prospect of reorganization, the court may dismiss the case, convert the case to a chapter 7 liquidation case or grant other relief to affected parties. Such action, however, is relatively rare, particularly at the outset of a chapter 11 case.

The Bankruptcy Code also provides that, for cause shown, the bankruptcy court may abstain from exercising jurisdiction over a bankruptcy case upon such terms as the court deems appropriate. One ground specifically mentioned in the Bankruptcy Code as justifying abstention is the pendency of a foreign proceeding, as a foreign enterprise may file a chapter 11 case as readily as a domestic enterprise, the usual prerequisite being the presence of property in the

United States. Although bankruptcy courts rarely abstain from exercising jurisdiction over a bankruptcy case, there is some authority supporting dismissal of the case on grounds of abstention when a foreign debtor has only tenuous ties to the United States.

d. <u>Duration of Chapter 11 Cases</u>

A debtor may remain in a chapter 11 reorganization case for an indefinite period of time. The longer a debtor is in chapter 11, the greater potential for stigma. While some chapter 11 cases conclude within a few months, a few have continued for over a decade; although every case is different, the best rule of thumb is that a large chapter 11 case will likely last for up to two years. The exact time it may take for a chapter 11 case to work itself through depends on many factors. First, obviously, is the debtor's ability to operate – the debtor must be able to sustain and/or finance its operations and to formulate a business plan providing for ongoing profitable operations. On that basis, it can then attempt to formulate an agreement with its creditors on the relative shares in the ownership of the business going forward. A case may continue for a particularly long period of time due to the complexity of the case or to the necessity of concluding litigation before an effective reorganization plan may be proposed. Accordingly, a case may languish due to the debtor's inaction and the lack of creditor interest. The United States trustee is charged with monitoring the progress of chapter 11 cases and with calling inactive cases to the attention of the bankruptcy court for dismissal or conversion.

If the bankruptcy court finds that the debtor is not making adequate progress toward reorganization, the court may order the case converted to a chapter 7 liquidation case or dismissed. Whether a debtor is making adequate progress toward reorganization is subject to a case-by-case analysis. Generally, courts give debtors significant leeway early in the case and less as the months go by.

e. <u>Commencement of an Ancillary Proceeding in Aid of a Foreign Proceeding</u>

The Bankruptcy Code provides a gateway through which foreign trustees, liquidators, receivers and similar functionaries, and sometimes foreign debtors, may seek various relief in the United States bankruptcy courts. The Bankruptcy Code makes available to a "foreign representative" of an estate in a "foreign proceeding" the following vehicles for relief: (i) commencement of an involuntary case; (ii) commencement of a case ancillary to a foreign proceeding; or (iii) dismissal of a case or suspension of all proceedings in a case. A foreign debtor that otherwise qualifies to be a debtor under the Bankruptcy Code may also commence a plenary case.

In addition to the statutory requirements, access to this gateway is governed by developing case law and judicial requirements. The laws of the United States, however, are not the only applicable rules. For instance, a Bankruptcy Code analysis may revolve around a foreign jurisdiction insolvency law to determine whether (i) access to the United States bankruptcy courts is permitted and (ii) relief is available and appropriate.

Ancillary proceedings under the Bankruptcy Code provide alternatives to the commencement of plenary cases. The principal goal of an ancillary proceeding is to permit foreign debtors to prevent the piecemeal distribution of assets in the United States by means of legal proceedings initiated in domestic courts by local creditors. Under the Bankruptcy Code, deference is accorded to the country where the primary insolvency proceeding is located.

§ 5.1.2. Effect of Commencement of a Bankruptcy Proceeding – The Protection of the Automatic Stay

The commencement of a bankruptcy case under any chapter of the Bankruptcy Code results in the immediate imposition of an automatic stay enjoining substantially all creditor action against the debtor and its property. The stay arises upon the commencement of the case and is effective regardless of whether creditors have actual notice of the commencement of the case. Actions taken in violation of the stay are considered void or voidable, and creditors who knowingly violate the automatic stay may be sanctioned. The automatic stay is a fundamental provision which provides the debtor protection from creditor actions to stabilize business operations.

The automatic stay is extremely broad in scope. It prohibits the commencement or continuation of proceedings against the debtor, the enforcement of any judgment against the debtor or property of the debtor's estate, any act to obtain possession of property of the estate or to exercise control over property of the estate, any act to create, perfect or enforce against property of the debtor, any lien securing a prepetition claim, any act to collect, assess or recover any prepetition claim against the debtor and the setoff of any debt owing to the debtor against any prepetition claims against the debtor. The automatic stay has been held to prohibit the sending of "dunning" letters to the debtor and the making of telephone calls to demand payment from the debtor. The automatic stay affects secured creditors as well as unsecured creditors. After a bankruptcy filing a secured creditor must cease all efforts to collect or dispose of collateral, although reasonable steps to protect collateral may be permissible.

The automatic stay prohibits a non-debtor party to a contract with the debtor from terminating the contract (even if the contract is terminable at will) and from enforcing the contract against the debtor with certain exceptions. There is conflicting authority as to the duty of a non-debtor party to a contract to perform its own obligations under a contract with a debtor prior to any assumption of the contract, particularly when the debtor is in default.

The automatic stay enjoins the postpetition enforcement of prepetition liens, injunctions, attachments, garnishments and the like. If the receiver or other custodian has taken possession of property of the estate, the receiver or custodian generally is required to turn over the property to the trustee or debtor in possession.

The Bankruptcy Code provides that an affected creditor may seek relief from the automatic stay for cause. Bankruptcy courts are reluctant to grant relief from stay to unsecured creditors, although in appropriate circumstances unsecured creditors may be granted relief from stay to continue with pending litigation or arbitration proceedings (usually with the requirement that the enforcement of any judgment or award against the debtor will remain stayed). A bankruptcy court may grant an unsecured creditor relief from stay when the creditor seeks to pursue a claim against the debtor as a nominal defendant for the purpose of reaching insurance proceeds or establishing rights against third parties.

A secured creditor is entitled to relief from stay if its interest in collateral is not being adequately protected. For example, if a secured creditor's collateral is declining in value or the creditor's equity in the collateral is decreasing as a result of the accrual of senior liens, the creditor may seek relief from the stay to proceed with its rights and remedies against its collateral. Courts are generally reluctant to grant relief from the stay early in a chapter 11 case, except if the debtor is not insuring or maintaining the collateral.

A secured creditor also is entitled to relief from stay with respect to its collateral if the debtor has no equity in the collateral (considering all liens against the collateral) and if the collateral is not necessary to an effective reorganization of the debtor. Proving that collateral is not necessary to an effective reorganization of the debtor often is difficult in the early stages of a chapter 11 case when the bankruptcy court generally will accept a debtor's representation that the collateral may be necessary to effect a chapter 11 plan. If, during the course of an extended reorganization effort, the creditor can show that the debtor lacks equity in collateral and either that the collateral no longer is necessary to any effective reorganization of the debtor or that the debtor has no prospects of effectively reorganizing, the bankruptcy court will grant relief from stay.

The automatic stay by its terms is applicable world-wide. A few judicial decisions recognize that as a practical matter a United States court cannot enforce its power in foreign countries and that foreign courts ordinarily will grant only limited recognition to United States Bankruptcy Court orders. Nevertheless, if the United States court can exercise jurisdiction over the creditor, directly or indirectly (or, in an extreme case, over an affiliate), the court will likely make every effort to enforce the automatic stay, which it views as essential to the survival of the enterprise and in the best interests of the general body of creditors (in the absence of very strong evidence to the contrary).

The foregoing has led to anomalies, where an enterprise or entrepreneur domiciled abroad but with some assets in the United States has filed under chapter 11 to gain the benefits of the statute. For at least a period of time, foreign creditors subject to United States jurisdiction generally may have to obey the strictures of the automatic stay while foreign creditors without a nexus to the United States may avoid United States jurisdiction altogether.

The commencement of a bankruptcy case affects the accrual of interest on obligations of the debtor. For purposes of receiving any distribution from the debtor's estate, whether under a plan of reorganization or otherwise, post-petition interest accrues on prepetition unsecured claims against a debtor only to the extent the debtor is solvent. Secured claims accrue interest to the extent of the value of the collateral; if the collateral is worth more than principal and pre-petition interest, the creditor will be deemed “oversecured.” For example, a creditor with a $100 claim holding collateral valued at $80 may not accrue post-petition interest on the claim for purposes of receiving any distribution from an insolvent debtor's estate. If a creditor holding a $100 claim against an insolvent debtor holds collateral valued at $110, however, the creditor will be entitled to accrue, up to $10, or (i) post-petition interest on its claim and (ii) as costs (and attorneys' fees) if they re provided for in an agreement between the debtor and the creditor. There is conflicting authority as to the rate at which interest accrues post-petition.

Notwithstanding the foregoing, interest continues to accrue on prepetition claims for purposes other than receiving distributions from the debtor's estate. For example, an unsecured creditor of an insolvent debtor may be able to recover post-petition interest from a non-debtor guarantor of the debt. If a debtor is denied a discharge entirely or with respect to a particular debt, the creditor is entitled to enforce the full amount of its claim, including post-petition interest, against the debtor.

§ 5.1.3. Administration of the Proceedings and the Key Players in Chapter 11

a. The Bankruptcy Court

Jurisdiction over cases commenced pursuant to the Bankruptcy Code lies exclusively in the United States Federal courts. The Federal courts have non-exclusive jurisdiction over controversies arising in or "related to" cases under the Bankruptcy Code. As a result of the automatic stay, which generally prohibits enforcement of claims against a debtor outside of the court with jurisdiction over the debtor's bankruptcy case, most controversies relating to a bankruptcy case as prosecuted in Federal court.

Original jurisdiction over bankruptcy cases and controversies is vested in the United States district courts, which are the general Federal trial courts. Pursuant to statute and local rule, however, each district court automatically refers bankruptcy cases and related controversies to a unit of the district court called the bankruptcy court. The bankruptcy court for each federal district is comprised of the bankruptcy judges serving in that district. Bankruptcy judges hear only bankruptcy cases and related matters and thereby become specialists in bankruptcy law and procedure.

Upon request, a district court may withdraw the reference of a bankruptcy case or proceeding and hear the matter itself. The withdrawal of the reference is mandatory in proceedings involving the application of both bankruptcy law and non-bankruptcy Federal law and is optional in other cases, and is rare as a matter of practice.

In general, the bankruptcy court sits as a trier of issues of fact or law that are brought to the court for determination by the debtor, a creditor of the debtor, an equity security holder or another party in interest. One of the purposes of the Bankruptcy Code was to separate the bankruptcy court from the day-to-day administration of the bankruptcy case, and the administration of the debtor's estate itself is left to the trustee, if one is appointed or elected, or to the debtor if the debtor remains in possession of its assets as a debtor in possession, and to the unsecured creditors committee, subject in each case to the supervision of the court to the extent required under the Bankruptcy Code.

The extent of the court's supervision and role varies. The Bankruptcy Code provides that if the trustee or debtor in possession proposes to take any action out of the ordinary course of business, including selling the debtor's property outside the ordinary course of business, the trustee or debtor in possession must request court approval of such sale by filing a motion with the court and obtaining an appropriate order. Twenty-days' notice is given to the creditors who have filed a request therefor, to any committee appointed in the case, and to certain other parties, although the Court has broad power to vary the notice period.

As a practical matter, although the court approves the proposed use or sale of property, the position of the creditors' committee is critical. If the committee does not object, the court will ordinarily approve the motion routinely. If there is an objection, it may still be difficult to get a bankruptcy court to second-guess the debtor's business judgment in proposing a transaction. However, the Court will review, among other things, the conditions of a sale of property, the notice provided to possible bidders, and any legal issues that may arise in connection with the sale, with the goal of insuring a fair and open auction process. The court itself does not sell the property or execute any instrument of conveyance.

Motions having a vital effect on the case may come before the court. If a party in interest brings the matter before the court, the court will decide whether a trustee should be appointed to continue to operate the debtor's business, whether an examiner should be appointed to investigate the debtor, whether a case should be converted from a case under chapter 11 to a case under another chapter, or whether a plan of reorganization should be confirmed. In chapter 11 the debtor has the exclusive right to propose a plan during the first 120 days, and this period can be extended by the court, on motion. Exclusivity extension motions tend to be a focus of attention by creditors and the debtor, where the creditors seek to push the debtor to propose a plan more quickly or lose exclusivity. At these hearings, the court will often consider whether the debtor is making sufficient "progress" on its plan to justify its retention of the tactical advantage of exclusivity.

The Bankruptcy Code permits the bankruptcy court to act upon its own motion only in limited circumstances. For example, a bankruptcy court may set status conferences from time to time and, at a status conference, set deadlines for the filing of papers, affecting the progress of the reorganization effort. However, if the creditors committee does not act, the court will rarely do so.

b. Unsecured Creditors and the Role of Creditors' Committees

The claims of certain unsecured creditors of a debtor in a bankruptcy case are granted priority pursuant to the Bankruptcy Code. Most unsecured claims, however, are not entitled to priority. In particular, unsecured claims arising from the provision of goods or services on open account (trade credit) or arising out of unsecured financing transactions ordinarily are not entitled to priority.

A source of creditor power in a chapter 11 case rests with the statutory unsecured creditors' committees appointed by the United States trustee pursuant to section 1102 of the Bankruptcy Code. In large chapter 11 cases, it is not unusual to have several committees appointed by the trustee, including a committee of holders of unsecured claims consisting of the debtor's large trade creditors, a bondholders' committee and, in rarer instances, a committee of equity security holders. In chapter 11 cases involving tort liability arising from, for example, the manufacture of products containing asbestos, the trustee often appoints a tort claimants' committee representing tort plaintiffs asserting claims against the debtor and its estate. Secured creditors are generally not permitted to be members of a creditors' committee because such committees are only for the benefit of holders of unsecured claims.

A creditors' committee provides an additional layer of oversight over the operations of the debtor. Significantly, the Bankruptcy Code gives a committee the ability to hire its own professionals (paid for by the debtor's estate) to investigate and scrutinize the debtor's activities during a chapter 11 case, as well as the role of insiders and transactions that occurred prior to the chapter 11 case. Specifically, the Bankruptcy Code allows a committee to exercise broad powers in the debtor’s chapter 11 case including (i) consulting with the debtor in possession or trustee regarding the administration of the case, (ii) investigating the debtor’s actions, decisions, and financial condition, (iii) active participation in the formulation of a chapter 11 plan, (iv) filing a motion with the court to have a trustee or examiner appointed to the case, and (v) exercising other general powers that further the reorganization process.

Depending on the particulars of each chapter 11 case, committees have varying degrees of influence. However, in most cases, a committee, consistent with its fiduciary duties to the specific creditors that comprise its constituency, closely monitors the debtor’s actions, reviews pleadings filed in the bankruptcy court, and participates in the hearings in respect of those pleadings. In addition, the committee often acts as a foil to the secured lenders and their attempts to exercise influence over the conduct of the chapter case. For example, a creditors’ committee can further negotiate the terms of a postpetition credit agreement or use of cash collateral after the debtor has finished negotiating the agreement with its secured lender. As discussed below, another important area of influence is the role of the creditors’ committee in negotiating a chapter 11 plan that will produce favorable results for its creditor constituency.

The effectiveness of creditors’ committees depends on multiple factors. First, creditors’ committees are made up of numerous (and sometimes fractious) constituents. Stronger, more effective committees are made up of creditors that have similar goals and interests, allowing the committee to negotiate on behalf of all of its constituents as one strong unified voice. Secondly, the effectiveness of creditors’ committees can be affected by the existence of multiple committees within a bankruptcy proceeding. The existence of multiple committees with differing goals can add or detract from the effectiveness of negotiations with the debtor, as well as with the secured creditors. For example, a creditors’ committee consisting of trade vendors may want the company to reorganize in order to maintain a significant customer; in contrast, a bondholders’ committee, after evaluating the liquidation value of the company, may be in favor of the company’s immediate liquidation.

Chapter 11 committees are usually made up of business representatives, who ideally are able to review management's business decisions and business plan. The committee invariably hires a lawyer to represent it in the proceedings, and usually an accountant to review the debtor's records and assist in the formulation of the business plan and the reorganization plan. The court-approved fees and expenses of such professionals and certain other expenses of the committee can be high, are chargeable to the debtor's estate as administrative expenses, and add to the cost of the proceeding.

Creditors may choose, before or after the commencement of a case, to appear individually or through representatives and be represented by counsel in their transactions with the debtor. For example, the indenture trustee under a trust indenture relating to bonds issued by the debtor will appear in a bankruptcy case on behalf of the bondholders. Ordinarily, the agent for a syndicate of banks or other lenders will appear on behalf of the syndicate. Creditors may form and appear by informal committees, where the committees' professionals are paid by the creditors rather than the estate. In cases where no creditors' committee is appointed or serving, the United States trustee may take a more active role in the case so as to protect the interests of unsecured creditors.

A strong creditors committee is important to the proper functioning of a chapter 11 case. As noted above, a trustee is not ordinarily appointed, on the theory that management, no matter what its faults, is more likely to find a business solution to a business problem than an outside trustee. The committee is expected to review management's activities and plans, as the creditors' "watchdog," and it has the right to bring to the court any complaints about the direction of the case and management's progress in formulating a plan. It is also expected to negotiate a plan – the fundamental premises of chapter 11 being that it is appropriate to allocate power among competing interests, provide them with expert assistance, and encourage them to negotiate a solution. Nevertheless, the committee is not expected to manage the debtor, and it is often very much the "junior partner" in the eyes of the court.

c. Secured Creditors

For purposes of the Bankruptcy Code, a creditor is deemed a secured creditor only to the extent of the value of the creditor's security interest in assets of the debtor's estate. For example, a creditor holding a $100 claim against a debtor secured by assets of the debtor worth only $80 is deemed to hold an $80 secured claim and a $20 unsecured claim.

Secured creditors, like all creditors of a debtor in a bankruptcy case, are subject to the automatic stay imposed upon the commencement of a bankruptcy case that enjoins substantially all creditor action to enforce claims against the debtor. The automatic stay enjoins a secured creditor from repossessing collateral, from disposing of collateral, and from exercising any control over the collateral. Upon demand, a secured creditor generally must turn over to the trustee or debtor in possession non-cash collateral within the secured creditor's possession or control. Cash collateral may, with the consent of the debtor, be escrowed under certain terms and conditions.

A secured creditor is entitled to "adequate protection" of its interest in its collateral. Accordingly, a secured creditor is entitled to have its collateral appropriate maintained and insured and is entitled to protection against loss or diminution in value of the collateral. The failure of a trustee or debtor in possession to adequately protect a secured creditor's interest in collateral constitutes grounds for the secured creditor's obtaining relief from stay to exercise its right and remedies with respect to the collateral.

A trustee or debtor in possession generally may use a secured creditor's non-cash collateral in the ordinary course of the debtor's business without the secured creditor's consent or court order. For example, if a plant or the inventory of the debtor's business is encumbered, the debtor may continue to use the plant and the inventory in its business. Asset forth above, however, if a trustee's or debtor in possession's use of a secured creditor's collateral impairs or threatens to impair the secured creditor's interest in the collateral, the secured creditor may demand adequate protection for its interest in the collateral or seek relief from stay on the grounds that the secured creditor has failed to receive such adequate protection. In so-called "single asset" cases, where a parcel of income-producing real property constitutes the primary asset of the debtor, the debtor's failure to adequately protect a secured creditor's interest in the property may also constitute grounds for conversion of the case to a chapter 7 case or dismissal of the case.

The rules relating to “cash collateral,” which includes cash, negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents, including the proceeds, rents and profits of collateral in which a secured creditor has an interest, are different. After the order for relief, a trustee or debtor in possession may not use cash collateral without the consent of the secured creditor or a court order. As a practical matter, if a secured creditor has a lien on a debtor's inventory and accounts receivable and the proceeds thereof, or if a secured creditor has a lien on a debtor's income-producing real property and the rents therefrom, there are strong incentives on both parties to negotiate a “cash collateral order,” or the terms on which the trustee or debtor in possession will be authorized to use cash collateral. If they cannot negotiate the terms, the court will have to determine on what basis the debtor will be able to access cash and what protection will be afforded to the secured creditor.

Often, a debtor in possession who desires to use cash collateral will propose that the secured creditor be granted a “replacement lien” on unencumbered assets of the debtor's estate (including inventory to be acquired or receivables to be generated from post-petition inventory) as adequate protection for the secured creditor's interest in existing cash collateral. For example, a debtor in possession may propose that the debtor be authorized to use collections on accounts receivable subject to a prepetition security interest on the condition that the affected secured creditor receive a replacement lien on newly generated post-petition accounts receivable. If the debtor in possession can convince the bankruptcy court that the operation of the debtor's business is likely to generate accounts receivable having a value equal to or greater than the collections proposed to be used – in other words, that the debtor will not continue to suffer losses – the bankruptcy court is likely to approve the proposal.

The Bankruptcy Code prohibits the appointment of a receiver in a bankruptcy case. Accordingly, when a debtor is failing to adequately protect a secured creditor's interest in collateral, the secured creditor's usual remedy is to obtain relief from stay in order to exercise its otherwise available rights and remedies against the collateral. Where such remedies include the appointment of a receiver to take possession of, to liquidate, or to otherwise exercise control over collateral, after obtaining relief from stay the secured creditor may apply to an appropriate non-bankruptcy court for the appointment of such a receiver. A chapter 11 plan of reorganization must provide for the secured creditor to receive payments or property that have a present value equal to the allowed amount of the secured creditor's claim.

d. Appointment of a Trustee or Examiner

The commencement of a chapter 11 reorganization case does not usually result in the appointment of a chapter 11 trustee. Rather, the chapter 11 debtor remains in possession of its assets and becomes known as a debtor in possession. A chapter 11 debtor in possession generally may exercise all powers granted to a chapter 11 trustee under the Bankruptcy Code.

The law is not altogether clear as to the control of a large corporate “debtor” in chapter 11. In theory, it is the management that is actually administering the enterprise. While the board of directors of a corporation is the source of authority outside of chapter 11, the power of the board in a chapter 11 case is limited, and the ultimate source of authority is the court. There are conflicting judicial decisions as to the power of shareholders, after a chapter 11 filing, to vote out a board and then install new management that is more responsive to shareholder interests, particularly as the fiduciary duty of the board and management is to creditors after a filing, unless the enterprise is solvent.

After the commencement of the case, on request of a party in interest or the United States Trustee, and after notice and a hearing, the court may order the appointment of a chapter 11 trustee for cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or if the court finds that the appointment of a trustee is in the interests of creditors, any equity security holders and other interests of the estate. The burden on the party seeking a trustee is a very heavy one, and bankruptcy courts are usually very reluctant to install a trustee unless there is truly gross mismanagement or fraud. "Ordinary" mismanagement, sufficient to get the enterprise into bankruptcy in the first place, is not enough.

The chapter 11 trustee is usually a businessman or someone with some experience in the debtor's industry, and it is expected that the trustee will continue those parts of the company's operations that are economically sound. After the appointment of a trustee for a corporate chapter 11 debtor, unless otherwise provided in a confirmed plan of reorganization, the corporation continues to exist as a fictitious legal entity and may continue to have shareholders and board of directors meetings. The trustee, however, replaces the board of directors as the director of the corporation's affairs.

Upon the appointment of a trustee in a chapter 11 case, the officers and other employees of the debtor retain their positions unless the trustee removes them.

In a chapter 11 case, where the court has not ordered the appointment of a trustee, on request of a party in interest or the United States trustee, and after notice and a hearing, the court may order the appointment of an examiner to conduct such an investigation of the debtor as is appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor if such appointment is in the interest of creditors, any equity security holders and other interests of the estate or if the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services or taxes, or owing to an insider, exceed $5 million.

f. Government Agencies

A United States trustee, an official of United States Department of Justice, is appointed for each Federal judicial district or group of districts to monitor the progress of local bankruptcy cases and to represent the interests of the United States government in the expeditious and efficient prosecution of such bankruptcy cases. The United States trustee is authorized to appear in all bankruptcy cases and proceedings.

In general, the United States trustee takes an active role in chapter 11 cases or controversies only when it appears that the adversarial system contemplated by the Bankruptcy Code is not working effectively to protect the interests of creditors or other parties in interest. For example, the United States trustee may take an active role in a chapter 11 case in which a creditors' committee has not been appointed, on the rationale that the interests of creditors may not be effectively represented in the case. Otherwise, the United States trustee often limits an active role to the review and comment on applications for payment from the assets of the debtor's estate ("fee applications") submitted by attorneys or other professionals employed by the debtor, a trustee or by a creditors committee.

In cases involving publicly held corporations or partnerships, the Securities and Exchange Commission, which is generally charged with insuring the fairness and efficient operation of securities markets, may appear to represent the interests of equity or other security holders. Other governmental agencies, such as the Internal Revenue Service, State and local tax agencies, the Pension Benefit Guaranty Corporation (which administers the Federal government's guaranty of certain pension benefits) and environmental regulatory authorities may appear to represent their economic or regulatory interests.

While there are no provisions in the Bankruptcy Code requiring the bankruptcy court to protect a specific "public interest," the courts have found that a primary purpose of a chapter 11 reorganization proceeding is to preserve the going concern value of an operating enterprise and avoid the economic disruption and employee dislocation which may occur upon the piecemeal liquidation of a business. Accordingly, bankruptcy courts tend to have a bias in favor of the maintenance of business operations and against piecemeal liquidation. The result of this bias is that debtors in chapter 11 reorganization cases may be permitted to continue to attempt to reorganize even over strong creditor objection.

§ 5.1.4. Financing in Chapter 11

A principal attraction of chapter 11 is that it allows debtors to obtain credit more readily than they would prior to a bankruptcy filing. The availability of financing to a debtor in possession is a key to the debtor's ability to continue as a going concern. Financing also signals creditors that the debtor is "open for business" and able to pay for goods and services. It also encourages vendors to provide terms to the debtor. Thus, the availability of postpetition financing (or DIP financing) further reduces the stigma of bankruptcy. A debtor's financial position prior to filing may simply be too chaotic to allow any possibility of new financing and liens and restrictions held by existing lenders may make the creation of a new debt (usually secured) impossible. Under chapter 11, a debtor can often obtain some financing consensually from prepetition lenders or a new lender – and sometimes even over the objection of the prepetition lenders. The rules are as follows:

(i) A chapter 11 trustee or debtor in possession is authorized to obtain unsecured credit on ordinary business terms. Claims arising out of the post-petition extension of credit on ordinary business terms, like other post-petition claims arising out of the ordinary course of the administration of the debtor's estate, are entitled to payment as expenses of administration with a first priority over payment of all other prepetition claims. An operating chapter 11 company is not usually able to obtain much trade credit at the outset of the case, and suppliers will usually insist on cash on delivery. However, if the debtor has been operating successfully for a time, and if it is able to get financing for a line of credit, some trade credit may return.

(ii) If ordinary course unsecured financing cannot be obtained, and financing is necessary for the continued administration of the debtor's estate, the trustee or debtor in possession may obtain financing pursuant to the provisions of the Bankruptcy Code specifically designed to encourage the financing of a debtor's estate. Most such financing is obtained on a secured basis, and the Bankruptcy Code has broad provisions whereby a trustee or debtor in possession may obtain required financing (called debtor in possession or DIP financing) by granting a new creditor a security interest, subject to existing liens, in some or all of the estate's assets to secure repayment of the credit extended. This security interest is perfected by court order, giving the lender a high degree of protection, and the creditor will be entitled to the rights of a secured creditor with respect to its collateral and also have a first position administrative priority claim for any unsecured deficiency. Indeed, it is common to provide DIP lenders with a super-priority over all other administrative claims. As the automatic stay would otherwise prohibit the new secured creditor from enforcing its liens against property of the estate, an agreement for the extension of post-petition secured credit commonly will set forth conditions upon which the secured creditor will have relief from stay to exercise its rights and remedies against its collateral.

The Bankruptcy Code contains a further, rather draconian provision to be utilized – or threatened – if pre-petition liens on the debtor's property are so large that there is not enough equity to collateralize needed DIP loans. If sufficient junior priority secured financing cannot be obtained, the trustee or debtor in possession may propose to obtain required financing by granting a new creditor a first-position lien on property of the estate, with priority even over existing liens and encumbrances on such property. Such a lien is commonly referred to as a priming lien, as the lien moves in front of all other existing liens. As the granting of a priming lien will affect the liens of the pre-existing lienholders, it cannot be granted over the objection of the pre-existing lienholders without adequate protection of their interests. Such adequate protection may take the form of a lien on unencumbered collateral, a junior lien on existing collateral or a replacement lien on future assets. The existence of an equity cushion (i.e., the existence of collateral value in excess of the total of all pre-existing and priming liens encumbering the collateral) may be held sufficient to adequately protect the interests of the affected pre-existing lienholders. Priming liens are rarely granted in practice, but a debtor's ability to obtain financing that would subordinate existing liens is a potent weapon that encourages lenders to extend or increase prepetition loans in the post-petition period.

§ 5.1.5. The Debtor's Estate

The commencement of a case under any chapter of the Bankruptcy Code creates an estate comprised of all legal and equitable interests of the debtor in property except that, in the case of individual debtors, the debtor may exclude from property of the estate property claimed as exempt.

An individual debtor under chapter 7 of the Bankruptcy Code may claim as exempt from property of the estate property which, under the law of the State of the debtor's residence, would be exempt from execution upon a judgment. Unless the State has chosen to “opt out” from the

Bankruptcy Code's exemption scheme, the debtor may, in the alternative, elect to exempt from property of the estate certain property described in the Bankruptcy Code.

Property of the estate does not include the equitable interest in property in which the debtor holds legal title for the benefit of another or a power which the debtor holds for the benefit of another. For example, if a debtor holds legal title to property as a trustee pursuant to a trust established for the benefit of *bona fide* third party beneficiaries, neither the equitable interest in the property nor the power to administer the property for the benefit of the beneficiaries will constitute property of the debtor's bankruptcy estate.

On the other hand, property of the debtor's estate will include any property which the trustee or the debtor in possession recovers based on the trustee's or debtor in possession's power to avoid and recover certain prepetition transfers. For example, if the trustee recovers real property transferred prior to the commencement of the case on the basis that the transferee failed to perfect its interest in the property, the property will become property of the estate.

Property of the estate also includes property the estate acquires in the ordinary course of its business or administration after the commencement of the case. Unless such after-acquired property constitutes the proceeds of property held by the debtor as of the commencement of the case that is subject to a valid security interest which encumbers both the property and its proceeds, the after-acquired property will not be subject to any prepetition security agreement.

In a chapter 7 or 11 case, the estate of an individual debtor does not include earnings of the individual earned after the commencement of the case. In other words, an individual's fresh start begins on the date of the filing of the petition as he can retain his personal earnings post-petition.

The Bankruptcy Code permits a trustee or debtor in possession to sell or use property (other than cash collateral) in the ordinary course of business without a court order. Use or sale of property out of the ordinary course requires court permission, obtained by filing a motion with the court and giving notice to all committees, creditors who have requested such notice and certain other parties. Sales of major assets may require an elaborate auction process with opportunity for third parties to outbid the prospective purchaser. In emergency circumstances, a debtor may be able to sell all or most of its property in an auction process where a prospective purchaser's bid is subject to higher and better offers. As a general rule, however, the courts prefer that a debtor sell all of its assets – or its stock in a recapitalization – in connection with a plan of reorganization, where the notice provisions are more elaborate and all creditors have the opportunity to vote on the plan.

It is not always easy to determine what actions by a debtor are in the ordinary course and do not require court approval and what requires a motion and an order. As a practical matter, the creditors committee monitors all of the material actions taken by a debtor and thus is in a position to review proposed action that may be borderline and also demand that certain matters be brought to the attention of the court. Under certain circumstances, a debtor is able to sell property in which a secured creditor has a security interest, after which all liens and encumbrances attach to the proceeds of sale.

§ 5.1.6. The Chapter 11 Plan

The goal of a chapter 11 reorganization is the filing and "confirmation" (court approval) of a chapter 11 plan. A plan is basically a detailed term sheet that sets forth the treatment to be accorded to parties in interest under the plan and the means for effectuating that treatment. Conceptually, the Bankruptcy Code gives the widest latitude to parties in interest in proposing the terms of plan. The plan may provide for the sale of some or all of the debtor's property, and for the cash to be distributed, or for the property to be distributed directly to creditors, or for a recapitalization where the debtor cancels some or all of its prior equity and distributes new equity to creditors. Many plans provide a combination of debt and equity, or cash, debt and equity. The former equity holders may, in some cases, put in new money to "buy back" the equity of the enterprise, and while the courts are split as to whether this can be done over the objection of creditors, there is no dispute that this can be accomplished consensually.

The reorganization plan, as a matter of economics, is ordinarily premised on a business plan that has been developed, usually by the debtor, and then thoroughly reviewed by the creditors committee and its professionals, as well as major secured creditors and other substantial parties in interest. A plan is considered consensual if each of the classes of parties in interest votes for the plan with the requisite majorities. A consensual plan has the widest latitude in terms of its provisions; there are, however, the following requirements for every plan:

1. Under the Bankruptcy Code, a chapter 11 plan of reorganization must classify parties in interest in appropriate classes and then describe the treatment of each class of claims and interests and contain adequate means for its implementation. Only similar claims may be placed in the same class. Similar claims may be placed in different classes if there is a valid reason for treating similar claims differently, but a plan of reorganization may not unfairly discriminate against a class of claims over the objection of such class.

Except to the extent such creditors may otherwise agree, holders of administrative and priority claims must receive payment in full, in cash, on the effective date of a plan of reorganization or as soon thereafter as is practicable, except that taxes may be stretched out, with interest, over six years. The claims of unsecured and other creditors and the interests of equity security holders may be impaired under a plan; a claim or interest is deemed impaired if the plan proposes to alter the rights or remedies of the holder of the claim or interest in any way. Secured creditors may agree to any treatment of their liens; otherwise, they must receive at least the "fair and equitable" treatment described below.

2. In order to be confirmed, a plan of reorganization ordinarily must be accepted by at least *one* class of claims or interests whose rights are impaired under the plan. A class of claims is deemed to have accepted a plan if a plan is accepted by creditors holding a majority in number *and* two-thirds in amounts of the claims in such class. A plan is accepted by the holders of a class of interests if such plan is accepted by two-thirds of such holders.

In order to solicit votes for a plan, a debtor or other plan proponent must send each holder whose vote is solicited a disclosure statement which has been approved by the bankruptcy court as containing adequate information to permit the holder to vote on the plan. In bankruptcy cases involving publicly-held companies, the disclosure statement typically contains some of the same kind of information that can be found in annual reports filed with the Securities and Exchange

Commission, plus other information required by the Bankruptcy Code or the bankruptcy court (e.g., a liquidation analysis).

A plan of reorganization may not be confirmed over the objection of a holder of a claim or interest unless such holder receives under the plan property having a value at least equal to the value the holder would receive upon liquidation of the debtor's estate. This is a major intellectual under-pinning of the reorganization provisions of the Bankruptcy Code: if each claimant receives at least as much as it would receive in a liquidation, it cannot complain that the reorganization process has damaged it. In addition, unless a class of claims or interest holders accepts the plan, the holders of claims or interests junior in priority to the subject class may not receive anything on account of their claims or interests until the holders in the subject class receive full payment on account of their claims or interests.

If the plan proponent is unable to obtain the acceptance of an impaired class of creditors or interest holders, the proponent may nevertheless obtain confirmation of the plan if the bankruptcy court finds that the plan is "fair and equitable" and does not discriminate unfairly against any class of claims or interest that is impaired under, and has not accepted, the plan. The term "fair and equitable" is specific and defined, not general. A plan is deemed fair and equitable with respect to a class of *secured* claims if the plan (i) provides that the holders of the claims retain their liens on property of the debtor's estate and receive deferred cash payments totaling at least the allowed amount of such claims of a value, as of the effective date of the plan, of at least the value of such holders' interest in the estate's interest in such property, *or* (ii) provides for the sale of such property with liens attaching to the proceeds of such sale (and the treatment of such liens as provided above) *or* (iii) otherwise provides for the realization by such holders of the indubitable equivalent of their claims.

A plan of reorganization is deemed "fair and equitable" with respect to a class of *unsecured* claims if the holder of each claim in such class receives property of a value, as of the effective date of the plan, equal to the allowed amount of such claim *or* if no junior class of claims or interests receives any distribution under the plan.

A plan of reorganization is deemed fair and equitable with respect to a class of interests if each holder of such an interest receives the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price to which such holder is entitled or the value of such interest, or if no junior class of interests receives or retains any property on account of the plan.

Unless a trustee has been appointed, the debtor in a chapter 11 case has the exclusive right to propose a plan of reorganization for 120 days after the entry of the order for relief. If a plan is proposed within such 120-day period, no other party may propose a plan unless the debtor fails to obtain acceptance of the plan by each impaired class within an additional 60-day period. Such time periods may be shortened or extended by the bankruptcy court at the request of the debtor (usually) or other party in interest.

Motions to extend exclusivity often become a critical focal point in chapter 11 cases, where the debtor attempts to retain its exclusive right to file a plan – and the bargaining power that seems to flow therefrom – and creditors (in some cases) attempt to terminate "exclusivity" and thereby gain the right to file an independent plan. Even where the creditors have no plan of their own to propose, termination of exclusivity or the threat thereof may induce the debtor to be more accommodating to creditors' interests in the formulation of the plan or the business plan on which it is based. Courts in some cases (particularly large, complex chapter 11's) have extended "exclusivity" for years in order to force a continuation of the negotiations on a plan among the debtor, the creditors committee and other parties in interest. Some judges look on the debtor as the only entity able to reconcile the competing interests of all the other parties and thus tend to extend exclusivity to keep the debtor "in control." If the debtor no longer holds the exclusive right to propose a plan, then any creditor or equity security holder may propose a plan, and there may be competing plans. Many judges view this as chaotic and costly and make every effort to prevent the filing of competing plans and to induce the parties to compromise.

3. A plan of reorganization must be confirmed by order of the bankruptcy court in order to become effective. In deciding whether to confirm the plan, the bankruptcy court determines whether the plan complies with all the requirements set forth in the Bankruptcy Code, many of which are outlined above. While consensual plans of reorganization (plans which have been accepted by each impaired class of claims or interests) usually are confirmed quickly, confirmation of a non-consensual plan of reorganization (sometimes referred to as a "cram-down" plan) may be bitterly contested and the hearings on confirmation of such a plan may take an extended period of time.

§ 5.1.6. The Effect of Confirmation of a Chapter 11 Case – Discharge of the Debtor

The confirmation of a plan of reorganization ordinarily discharges the corporate debtor from liability for all debts arising prior to the effective date of the plan of reorganization, except to the extent that the plan of reorganization otherwise provides. Some courts hold that a chapter 11 plan of reorganization does not discharge the debtor from liability to creditors who did not receive notice of the bankruptcy case sufficient to permit such creditors to participate. Some courts also have held that a chapter 11 plan of reorganization does not discharge the debtor from liability to creditors whose claims have not ripened into existence as of the effective date of the plan, but this is an issue that ordinarily arises only in connection with personal injury or property damage claims and environmental claims. Otherwise, the thrust of the Bankruptcy Code is to include in the bankruptcy process all prepetition liabilities, and the definition of "claim" is very broad.

In the case of an individual debtor, a chapter 11 plan of reorganization may not discharge the debtor from liability for all of the debtor's debts. For example, a chapter 11 plan of reorganization does not discharge an individual debtor from liability for alimony or child support, most taxes, fraud or willful or malicious injury to the person or property of another. In order to prevent a debtor from discharging certain debts, the creditor must timely file and successfully prosecute an objection to the dischargeability of the debtor's liability for such debt. An individual debtor may also be denied a discharge entirely if the individual has engaged in certain bankruptcy-related wrongs, such as concealing assets from creditors, failing to account for the loss or disappearance of assets or making a false oath in connection with the case.

A confirmed plan of reorganization is binding upon the debtor, all creditors of the debtor and all equity security holders in the debtor. The provisions of a confirmed plan of reorganization which has become effective constitute a contract between the reorganized debtor and those who receive or retain claims or interests under the plan. The debtor's breach of its obligations under the plan entitles an affected creditor or security holder to exercise such rights and remedies as are provided under the plan or by applicable non-bankruptcy law. For example, if a plan of reorganization provides that debtor will make payment of a certain amount to creditors on a certain date, unless the plan provides some other exclusive remedy or otherwise limits the rights of affected creditors, upon the debtor's failure to make the payment, creditors may sue the reorganized debtor for payment in an appropriate non-bankruptcy court.

If a debtor is unable to effectuate a confirmed plan, the debtor's case may be converted to a chapter 7 case. If a debtor is unable to comply with the provisions of a plan of reorganization which has become effective, the debtor may file a new chapter 11 petition in a renewed effort to reorganize its affairs. Some companies have gone through chapter 11 bankruptcy several times and multiple filings have become so common that they are sometimes referenced as "Chapter 22."

The Bankruptcy Court retains jurisdiction over the debtor and its estate until the effective date of the plan and thereafter for so long as is necessary to carry out the provisions of the plan. Quite commonly, disputes about the amount or allowability of claims against the debtor, or causes of action held by the debtor will not have been resolved by the effective date of the plan. In these circumstances, the Bankruptcy Court will retain jurisdiction to hear and determine these matters, which may be of strategic importance to creditor's claims.

Once the retention of jurisdiction by the Bankruptcy Court is no longer necessary, the debtor submits a final report to the Court and the case is closed. The closing of a case, however, has little practical significance. If necessary or appropriate to carry out the provisions of the plan or otherwise effectuate the purposes of the Bankruptcy Code with respect to the plan, the Bankruptcy Court may reopen the case to take whatever action may be appropriate.

§ 5.1.8. The Stigma of Failure

In the United States, the commencement of a chapter 7 liquidation by a company is an admission that the business enterprise has failed. The denial of confirmation of a plan of reorganization alone ordinarily has no effect upon the business or affairs of a chapter 11 debtor. Except as the court may otherwise order, a debtor in possession whose plan of reorganization has been rejected may continue to operate its business as though no plan had ever been proposed and may seek confirmation of another plan. The failure to confirm a plan of reorganization within a reasonable period of time, however, may constitute grounds for the conversion or dismissal of the case. If the case is converted to a case under chapter 7 of the Bankruptcy Code, then the case proceeds from the date of conversion as a liquidation case. If the case is dismissed, the debtor recovers any remaining assets but must operate or liquidate without the benefit of the automatic stay and other protections of bankruptcy.

A debtor in possession in a chapter 11 case which was voluntarily commenced as a chapter 11 case has the unilateral right to convert the case to a chapter 7 case at any time, provided that the debtor is eligible to be a debtor in a chapter 7 case. A chapter 11 case may be converted to a chapter 7 case over the debtor's objection, or dismissed, however, only by an order of the Bankruptcy Court.

A debtor may liquidate its assets in an orderly fashion under chapter 11. The objective of a "liquidating" chapter 11 case is to maximize the return to creditors and, if the debtor is solvent, to the owners of the enterprise. During a liquidating chapter 11 case, the chapter 11 debtor in possession (or a chapter 11 trustee) attempts to sell or dispose of all or substantially all the assets of the debtor's estate, ordinarily as a going concern, and the plan of reorganization simply provides for the liquidation of any remaining assets and for the distribution of the proceeds of the liquidation to creditors and to owners in accordance with the priorities of their claims and interests.

A debtor may prefer chapter 11 liquidation in a chapter 11 case over liquidation outside of bankruptcy as the debtor in a chapter 11 case obtains the benefits of the automatic stay and a trustee's power to avoid and recover preferential, fraudulent and other transfers. A debtor may prefer liquidation in a chapter 11 case over liquidation in a chapter 7 case because unless a chapter 11 trustee is appointed, the debtor will remain in control of its business and property as a debtor in possession and the debtor may continue to operate while the liquidation is conducted. This may make it more likely to obtain going concern values rather than liquidation values. Creditors may agree to a chapter 11 liquidation in order to avoid chapter 7 expenses, because they believe the debtor will be able to maximize the value of the its property better than a trustee unfamiliar with the debtor's business and property, or simply because the creditors committee plays a more important role in chapter 11 and tends to surrender its powers to a chapter 7 trustee. The usual predicate to a debtor remaining in chapter 11 is that the committee has some degree of confidence in the chapter 11 management, but there are several cases in which management has been replaced by a "responsible officer" who will control the debtor but who will not be either a chapter 11 or chapter 7 trustee.

More frequently, however, liquidation under the Bankruptcy Code proceeds in a case under chapter 7 of the Bankruptcy Code. In a chapter 7 case, a trustee automatically is appointed or elected and the primary objective of the case is the prompt and equitable distribution of the proceeds of liquidation of the debtor's estate. While a chapter 7 trustee may be authorized by the bankruptcy court to operate the business of a chapter 7 debtor on a temporary basis if necessary to maximize the value of the debtor's estate, ordinarily a chapter 7 trustee conducts no business other than marshalling and liquidating the property of the estate.

Chapter 5.2. Legal Effects Of Bankruptcy

The commencement of a bankruptcy case legally adjusts the relationship between a debtor and its creditors. As discussed above, the commencement of bankruptcy triggers the automatic stay, which suspends the debtor's obligation to pay prepetition claims, including secured and unsecured claims, judgments and penalties. The automatic stay further prevents creditors from taking any action against property of the debtor's estate, including foreclosure actions and the execution of judgments. See 5.1.2. In addition, the Bankruptcy Code permits a debtor to distribute to its creditors (in particular unsecured creditors) less than one hundred percent of their claim and yet be discharged of debts and claims (with certain exceptions). The readjustment of the debtor/creditor relationship is a substantial modification of the legal rights of the parties, all premised on the goal of providing debtor with a fresh start, free of the stigma of insolvency.

In addition to the automatic stay and the adjustment of debtor/creditor relationships, bankruptcy proceedings in the United States produce a variety of results. The options are reorganizations, partial divestiture of assets with a reorganization around a core group of assets, a sale of substantially all of the assets pursuant to an auction process (followed by liquidation), or a liquidation of the assets at a distressed sale. In stark contrast, chapter 7 is chosen when liquidation by a chapter 7 trustee is the only alternative. This alternative is generally chosen by small businesses with little or no assets to be distributed to creditors. A chapter 11 case can produce the following results:

(1) the debtor is reorganized with (a) the existing creditor constituency receiving one hundred percent payment on account of their claims, leaving existing equity in place; (b) creditors are paid less than one hundred percent of their claims, and receive a combination of cash, debt and/or equity, with existing equity expunged; (c) creditors become the sole equity holders in satisfaction of their claims; (d) existing equity remain the owners through a cash infusion to pay creditors (also known as a "new value plan"); and (e) with a cash infusion from outside investors and some distribution to creditors after which the outside investor owns the company. In each scenario, the debtor receives a discharge of its debts to the extent dischargeable. In each instant, the debtor is able to seek and obtain "exit" financing to fund its working capital needs upon emergence from chapter 11; or

(2) the debtor divests certain divisions (pursuant to an auction process) and reorganizes around a core group of assets and makes distributions to creditors as set forth above; or

(3) the debtor seeks to sell substantially all of its assets pursuant to an auction process and distributes the proceeds to creditors through a liquidating plan; or

(4) the debtor is unable to reorganize or sell its assets and converts to a chapter 7 liquidation proceeding.

With this as a backdrop, the Bankruptcy Code serves to encourage reorganization or the sale of the enterprise. In the case of reorganization, the company makes a distribution to creditors, including cash, debt and, in some instances, equity. In some instances, existing management is rewarded under a plan through the issuance of stock and stock options. The only prohibition is that new equity issued under a plan may not be "non-voting securities."

Rather than chilling new investments in a debtor, the Bankruptcy Code encourages and facilitates mergers and acquisitions by providing mechanisms for the debtor (or its creditor constituency) to identify or respond to parties interested in acquiring some or substantially all of a debtor's assets. Purchasers of assets in bankruptcy are common-place since under the Bankruptcy Code purchasers are afforded significant protections not generally available outside of bankruptcy. For example, a debtor's assets are sold free and clear of liens, claims, encumbrances and other interests, including secured claims and statutory liens, with such liens attaching to the proceeds of sale. In addition, the purchaser may qualify as a "good faith" purchaser and acquire the assets free of vicarious and successor liability.

The decision to commence a chapter 11case is ultimately premised on the goal to reorganize with a discharge of debts and claims. Generally, there is no restriction or legal obstacles regarding the filing for bankruptcy other than a filing in bad faith. See Section 5.1.1.c.

Individual debtors granted a discharge under chapter 7 or chapter 11 are not entitled to another discharge within six years of a prior case which effectively prohibits a chapter 7 filing.

Chapter 5.3. Responsibility of the Company's Management and Effects of Bankruptcy.

Outside of chapter 11, under state law, officers and directors of a company owe fiduciary obligations to shareholders -- these obligations include the duty of care and the duty of loyalty. Breach of such duty exposes officers and directors to individual liability. In simple terms, the duty of care requires that officers and directors exercise the care that an ordinarily prudent person would exercise under similar circumstances and the duty of loyalty prohibits faithlessness and self-dealing.

Although officers and directors of a solvent corporation do not owe a fiduciary duty to creditors, the reverse is true when the corporation moves into the zone of insolvency. In this area, the fiduciary duty of the officer and director shifts from the stockholders to the creditors. Accordingly, in the case of an insolvent corporation, the officers and directors owe duties to creditors first who are the real stakeholders of the company, and stockholders second who shares are presumptively worthless. The rationale underlining the shift of duties is simple; before insolvency, shareholders own the corporation, upon insolvency, the creditors are viewed as the equitable owners of the corporation because they are the only parties who have an interest in the corporate assets.

The availability of releases and indemnification for officers and directors has been a perennial concern for those individuals who are in management, on the board of directors or in control of a company that is on the brink of insolvency and contemplating filing bankruptcy. Traditionally, large companies carry director and officer insurance which protects officers and directors for any actions taken in derogation of their twin duties of loyalty and care generally to the extent such actions are not the result of gross negligence or willful misconduct. Most corporate bylaws also provide indemnification provisions for officers and directors which provisions are generally backed up by director and officer insurance.

When a company files for chapter 11, actions of the officers and directors taken prior to the chapter 11 case undergo intense scrutiny by the creditor constituency, including the creditors' committee or committee of equity holders, if the latter is appointed in the chapter 11 case. Therefore, one of the great concerns for officers and directors who remain with the company through the chapter 11 process is the availability of releases and indemnification for acts taken prior to the commencement of and during the chapter 11 case under a chapter 11 plan that bind in all creditors and equity holders. Over the past several decades, numerous bankruptcy and appellate courts have weighed in on the availability of releases for officers and directors. There is no uniform rule governing releases of officers and directors. However, the following factors are evaluated in assessing the availability of a release:

(i) There is an identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the non-debtor is, in essence, a suit against the debtor or will deplete assets of the estate.

(ii) The non-debtor has contributed substantial assets to the reorganization.

(iii) The injunction is essential to reorganization. Without it, there is little likelihood of success.

(iv) A substantial majority of the creditors agree to such injunction, specifically, the impacted class, or classes, has "overwhelmingly" voted to accept the proposed plan treatment.

(v) The plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.

These factors are not an exclusive list of the considerations, nor are they a list of conjunctive requirements.

After a company emerges from chapter 11, there are no penalties assessed on management. Absent a release, management may be held liable individually if a creditor successfully prosecutes a cause of action against such individual. Unless management is subject to a non-compete agreement, individuals are free to engage in new enterprises. The only deterrent is whether such individual's reputation is adversely impacted by an unsuccessful reorganization.

In addition to releases, under a chapter 11 plan, management, members of the creditors' committee and their respective professionals are exculpated from any actions taken during the chapter 11 case, except for gross negligence and willful misconduct. One of the benefits for a company in chapter 11 is that actions taken out of the ordinary course of a debtor's business, i.e., sale of assets or extraordinary acts, are subject to bankruptcy court approval which serves to insulate management from any subsequent charges of misconduct.

During a chapter 11 case, management is often rewarded through retention bonus and incentive compensation programs. These programs are subject to Bankruptcy Court approval and are proposed to ensure that key management and employees do not leave the company during its reorganization. Retention bonuses are paid generally for time served; incentive compensation is paid if the debtor achieves certain benchmarks during the chapter 11 case, including filing and confirming a chapter 11 plan by dates certain and achieving financial targets. These programs are another way to mitigate the stigma of chapter 11 by encouraging management to remain with the company notwithstanding job offers from competitors or other financially sound companies.

Title 6. Prospects and Recommendations

On a whole, the Bankruptcy Code performs remarkably well, balancing the concerns and interests of debtors and creditors, to achieve the overarching goals of chapter 11 which are to achieve reorganization and maximize returns to creditors. Reorganization serves to preserve companies as going concerns and stimulate the economy by maintaining trading partners and jobs. The Bankruptcy Code provides the flexibility for a company to either reorganize or liquidate, if reorganization cannot be achieved. The system is not without critics on both sides of the debtor/creditor equation. However, the cast of characters in chapter 11 cases serves to maintain the "level playing field" so that no one player has an unreasonably dominant role.

Over the past twenty-two years, the Bankruptcy Code has been modified to address special interests, including labor unions, secured lenders, aircraft lessors, and owners of commercial realty and shopping centers. As a consequence, the Bankruptcy Code continues to be a work in progress. Amendments to the Bankruptcy Code have been expected to be adopted by Congress for the last several years. The proposed changes stem primarily from the National Bankruptcy Review Commission's lengthy and critical analysis of bankruptcy reform. The Commission was appointed by Congress to evaluate purported deficiencies and abuses under the Bankruptcy Code. The proposed amendments focus primarily on restricting consumer bankruptcies, including an individual's ability to file for a chapter 7 liquidation versus a chapter 13 individual "reorganization" by implementing a "means test" for financial eligibility. Much of the pressure for reform of individual bankruptcies comes from the banking and lending institutions that have seen significant losses through bankruptcy discharge of credit card debt. Some of the proposed amendments impact chapter 11, in particular, shortening the length of time a debtor has the exclusive right to file a plan and the ability to "reject" or terminate leases of nonresidential real property. As amendments are passed and the Bankruptcy Code evolves, debtors and their creditors will continue to develop strategies to achieve their respective goals.

Title 7. State of knowledge

1. <u>Laws, Rules and Guidelines Applicable to Bankruptcy Practice</u>:

   The Bankruptcy Code with Legislative History

   Federal Rules of Bankruptcy Procedure

   Local Bankruptcy Rules

   United States Trustee's Guidelines

2. <u>Case Law Reporters</u>:

   West's Bankruptcy Law Reporter

   Bankruptcy Court Decisions – Corporate Reorganization Reporter

   Collier Bankruptcy Cases, 2d Series

   C.C.H. Bankruptcy Law Reporter

   BNA Reporter

3. <u>Treatises</u>:

   <u>Collier on Bankruptcy 15th Edition Revised</u> (2000)

Norton Bankruptcy Law and Practice (Clark Boardman Callaghan (West Group)) Bankruptcy Services: Lawyers' Edition (West Publishing Co.) Cowans Bankruptcy Law and Practice (West Publishing Co.)

Cherkis & King, Collier Real Estate Transactions and the Bankruptcy Code (Matthew Bender & Co.)

Resnick & Weintraub, Bankruptcy Law Manual (Warren, Gorham & Lamont)

Bienenstock, Bankruptcy Reorganizations (Practising Law Institute)

4. Additional Research Tools:

The Practising Law Institute, ALI-ABA

The American Bankruptcy Institute

The Commercial Law League

CCLA Fund for Public Education, The American Bar Association

5. Recent Law Review Articles:

Joseph Samet, Understanding the Basics of Bankruptcy & Reorganization 2001: Available Research Tools for Bankruptcy Practice, 828 PLI/Comm 23 (Winter/2001)

David G. Epstein, Understanding the Basics of Bankruptcy & Reorganization 2001: Basics of the Automatic Stay, 828 PLI/Comm 239 (Winter/2001)

Jon Slatkin, Practical Approaches to Selling Assets in Chapter 11, 20-OCT Am. Bankr. Inst. J. 24 (October, 2001)

Corinne Ball & Jacqueline B. Stuart, The Battle Over Bankruptcy Law for the New Millennium, 55 Bus. Law. 1467 (May, 2000)

David S. Kennedy & R. Spencer Clift, III, An Historical Analysis for Insolvency Laws and Their Impact on the Role, Power, and Jurisdiction of Today's United States Bankruptcy Court and its Judicial Officers, 9 J Bankr. L.& Prac. 165 (January/February, 2000)

Robert B. Millner, What does It Mean for Directors of Financially Troubled Corporations to have Fiduciary Duties to Creditors? 9 J Bankr. L. & Prac. 201 (January/February, 2000)

Lynn M. LoPucki & Sara D. Kalin, The Failure of Public Company Bankruptcies in Delaware and New York: Empericial Evidence of a "Race to the Bottom", 54 Vand. L. Rev. 231 (March 2001)

Kimberly L. Nelson, Abusive Filings: Can Courts Stop the Abuse Within the Confines of the Bankruptcy Court? 17 Bankr. Dev. J. 331 (2000);

Michael L. Cook, Professional Retention, Payment and Ethical Disputes, 810 PLI/Comm 689 (November, 2000)

Marcia L. Goldstein & Adam C. Rogoff, Plan Acceptance, Disclosure Criteria and the SEC's Role in Chapter 11 Cases, 810 PLI/Comm 1039 (November, 2000)

6. Bankruptcy Web Sites:

ABI World
www.abiworld.org/

The Bankruptcy Law Finder
www.agin.com/lawfind\default.html

Internet Bankruptcy Law Library ("IBL") – Worldwide Troubled Company Resources
http://bankrupt.com/

LII Legal Information Institute – Bankruptcy: an overview
www.law.cornell.edu/topics/bankruptcy.html

Bankruptcydata.com
Bankruptcydata.com