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RETHINKING CHAPTER 11

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1. Introduction

There is substantial activity in the United States examining the working of chapter 11 and whether it needs major revision to work better for the modern economy and finance system. An efficient and effective insolvency system must grow out of the legal, economic and financial system in which it operates.

The economic and financial system that existed in 1978 when Congress enacted chapter 11 has changed dramatically. In 1978, companies typically had substantial unsecured debt for borrowed money and for purchased inventory. Their secured debt was typically secured only by specific assets such as equipment, inventory or accounts receivable, not by all or substantially all of their assets, so that the companies typically had more than a nominal amount of unencumbered assets. Trade debt was a significantly larger proportion of a distressed debtor's liabilities compared to bank or bond debt. Trade suppliers were often interested in compromising their claims to keep a customer in business but still sought maximum recovery. Most debt for borrowed money came from banks rather than the capital markets. Banks held their loans, did not mark the loans to market (but took reserves on distressed loans), wished to collect as much as possible, were legally prohibited from taking equity in exchange for their claims and often wished to preserve their borrowers as bank customers. Most of a debtor's assets were tangible assets, rather than intangibles such as intellectual property and contract rights and relationships. Reorganizing companies did not often include complex corporate groups.

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[1] The views expressed in this paper are those of the authors and do not necessarily reflect the views of either of their law firms, their firms' clients or the UCLA School of Law. The authors gratefully acknowledge the currently unpublished work in progress of committees of the National Bankruptcy Conference (www.nbconf.org) in helping to inform their views. For an elaboration of some of these ideas on the topic of sales by one of the members of the Conference, see Douglas G. Baird, *Lessons From The Automobile Reorganizations*, J. LEGAL ANAL. (Feb. 28, 2012).

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The economic and financial environment today differs markedly. A large debtor typically has substantial debt for borrowed money, whether from bank loans or capital market debts; trade debt is a relatively insignificant part of the company's capital structure. A lender typically takes a security interest in all of a company's assets, and often there is a second, and sometimes a third or fourth, priority security interest encumbering those assets as well. A distressed borrower seldom has any unencumbered assets. Trade suppliers typically have better credit management and find that writing off their claims or selling them at a discount is better than spending time trying to collect. An active market has developed not only for trade claims but also for bank loans and non-public capital market debts, so that banks and bondholders, as well as suppliers, can exit a credit by immediate sale to a purchaser who is willing to pursue collection through the bankruptcy process, often with a view to acquiring the reorganized company or simply re-trading the claim at a profit. Banks mark their loans to market, creating an incentive to take advantage of the opportunity to monetize their distressed assets rather than working to collect. Banks' business models have changed from lending institutions to financial intermediaries who arrange loans but often do not hold them. Modern companies rely far more on contractual relationships—virtual companies that outsource many of their functions—and on owned or licensed intellectual property, such as patents, copyrights, trademarks and technical know-how. Large corporate groups, many of them trans-national enterprises, are common in chapter 11 today. Transactions in the assets or ownership interests of distressed companies are now common and relatively easily accomplished.

Although its fundamental structure and principles have not been amended since 1978, chapter 11, and the judges and lawyers who operate the system, have done extraordinary work to make the system handle distressed companies and preserve going concern values, jobs and capital investments through sale or reorganization. However, the chapter 11 system is itself in distress, having been asked to do far more than it was designed to do and to operate in an entirely different environment. There are increasing disputes in cases over the fairness, efficiency and cost of chapter 11's operation. As a result, several efforts are underway among the practicing bar to rethink chapter 11, with a view toward making it work with today's (and tomorrow's) economic and financial system.

Ironically, as this reform effort is beginning in the United States, many other countries are continuing to adopt some of the basic principles of chapter 11. These include self-administration (debtor in possession model), the ability to convert debt to equity and dilute or eliminate existing shareholders without shareholder consent (cram down), priority for lenders to a reorganizing company (debtor in possession financing) and effective creditors committees. As chapter 11 reform efforts proceed, what can the United States learn from the reform efforts in other countries, whose systems have been adopted in more recent times? What effect might the United States reform efforts and conclusions have on the reform efforts in other countries, both those who have recently revised their laws and those who have not done so in modern times?

This paper considers only four major issues that are the subject of current reform discussions: Governance of the reorganizing company and of the chapter 11 process, financing of the business during the reorganization (DIP financing), sale of all or substantially all of the business's assets, and reorganization plan voting and distribution issues.

2. Governance

2.1. Self-administration (debtor in possession vs. monitor, administrator, trustee)

In the reform debate in the United States, there is little serious questioning of the self-administration (debtor in possession) model. First, the original reason for adopting the self-administration models still applies today. Management is less willing to commence a reorganization case if it knows that it will lose its employment immediately upon doing so, especially in small, closely-held corporations when there is an identity between owners and managers. Admittedly, there are many other reasons that deter management from opening a reorganization case, such as denial and terminal optimism. Still, removing one impediment is useful in encouraging management to confront financial problems and seek the protection that insolvency proceedings can provide.

More recent developments suggest that self-administration does not necessarily leave in place management that was responsible for failure in place. Research shows that senior management changes in most cases shortly before, during or at the conclusion of a reorganization case. See Ethan S. Bernstein, *All's Fair in Love, War & Bankruptcy? Corporate Governance Implications of CEO Turnover in Financial Distress*, 11 STAN. J.L. BUS. & FIN. 299 (2006). Even in cases of spectacular fraud (such as Enron and WorldCom) or suspected incompetence (such as Lehman), experienced crisis and turnaround managers assume senior management's duties at the beginning of the reorganization process, for example as a Chief Executive Officer or Chief Restructuring Officer. This process permits a more organic management transition and one that is influenced by those with money at stake, whether it is the shareholders, the lenders, or other creditors. There is little support for a formalization of this process such as by requiring the appointment of a turnaround manager during a reorganization case.

2.2. Role of Secured Lenders

Self-administration does not, however, leave management with unfettered discretion. Other forces limit management's discretion in operational and distributional decisions. Secured lenders, whether they lent before the reorganization or are financing operations during the case, take an active and interested role in policing management, both through restrictions imposed in the loan documents, exercise of statutory provisions designed to protect against loss in the value of their collateral during the case, and their general right to appear and be heard before the court in the case. Robin Phelan and Ocean Tama, *The Use of DIP Financing As A Mechanism To Control The Corporate Restructuring Process*, 44 TEX J. BUS. L. 15 (2011). To the extent that there is call for reform in these monitoring functions, as discussed more fully in part 3 below, it is to lessen an almost absolute-veto power that lenders financing a reorganization case often seek in their loan documents, so that other interests in the case are protected. Some courts have imposed limits on what controls a reorganization lender may take, *In re First Magnus Corp.*, 390 B.R. 667 (Bankr. D. Ariz. 2008), and the Federal Rules of Bankruptcy Procedure now require that a motion to approve reorganization financing specifically identify certain creditor control features in the loan, such as imposition of a deadline for filing a reorganization plan. Fed. R. Bankr. P. 4001(c).

Commentators question the role of secured lenders in dictating management structure or changes. Harvey R. Miller & Shai Y. Waisman, *The Creditor in Possession*, 21 No. 1 BANKR. STRATEGIST 1, 4 (2003). Reform efforts focus on limiting the power of secured lenders to dictate management changes. The portion of this paper addressing financing discusses those pressures.

Like secured creditors, unsecured creditors' committees often attempt to exert substantial control over the operations of a debtor in possession, reviewing, commenting on and negotiating all significant operational decisions as well as distributional decisions relating to the reorganization plan. They base these efforts on a statutory provision, not on any contractual right. In any large case, there is a committee of unsecured creditors, appointed by a Department of Justice official. The statute defines the committee's role very loosely:

> "(1) consult with the trustee or debtor in possession concerning the administration of the case;
> "(2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
> "(3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
> "(4) request the appointment of a trustee or examiner under section 1104 of this title; and
> "(5) perform such other services as are in the interest of those represented."

11 U.S.C. § 1103(c). In practice, creditors committees have given these duties a broad interpretation and now typically operate as a junior partner in the management of the case and the operations of the business. They expect to be consulted on all significant (and even some insignificant) operating decisions and often participate in every court hearing, even when their constituents' interests are completely aligned with the position that the debtor in possession takes.

One recent court decision disbanding a committee shows how they can extend their role of providing representation of unsecured creditors and limited supervision of a debtor in possession. After the appointment of a trustee in a chapter 11 case, the committee continued to participate in the case, taking extensive discovery ostensibly to protect creditors' interests but not actually contributing to case's progress. The court disbanded the committee, because it was causing an increase in administrative burden and expenses in the case. *In re Pacific Ave., LLC*, 2012 Bankr. LEXIS 1444 (Bankr. W.D.N.C. Jan. 26, 2012).

As a result, some reform advocates suggest limiting the unsecured creditors' committee's role. The National Bankruptcy Conference, in commenting on guideline for the allowance of fees in reorganization cases, suggested that fees for committee professionals should not be allowed where the committee's effort simply duplicates the efforts already being expended on behalf of the estate by the representative of the estate (trustee or debtor in possession). NAT'L BANKR. CONF., *Comments On The Proposed Guidelines For Reviewing Applications For Compensation & Reimbursement Of Expenses Filed Under 11 U.S.C. § 330 By Attorneys In Larger Chapter 11 Cases*, pp. 5-6, http://www.nbconf.org/images/NBC%20Comments%20on%20Proposed%20UST%20Fee%20Guidelines.pdf, Jan. 30, 2012, last viewed Apr. 29, 2012.

2.3. Role of Committees (scope of interests, whose money is at stake, differences in operational and distributional decisions)

Secured lenders typically are organized under their loan documents, with an agent acting as a focal point for discussion and decisions. Unsecured creditors (other than bondholders, who may be loosely represented by an indenture trustee) do not have a similar organizing mechanism through which they can protect their interests. The Bankruptcy Code supplies it through the mandatory appointment of an unsecured creditors' committee. 11 U.S.C. § 1102(a). When the company's value is materially less than the amount of a claim secured by a pervasive security interest, however, some commentators question whether the unsecured creditors should have any voice at all, let alone the expansive voice that section 1103(c) provides. The difficulty in determining whether an unsecured creditors' committee should be limited or eliminated in a case would depend almost entirely on valuation, an inexact art, which even at its best gives different answers as time passes. The problem in attempting a valuation at the beginning of a case simply to determine what rights, if any, a committee should have, is apparent. And without a committee representing the unsecured creditors, there would not likely be any effective check on an undervaluation by the secured creditors or on the validity of their claims and liens. The debtor in possession, though a fiduciary for the entire body of stakeholders in the bankruptcy estate, has little incentive to challenge the secured creditor when, even if the secured creditors' lien or valuation were suspect, there would be only enough value left for unsecured creditors, and none for equity holders.

The problems with an unsecured creditors' committee are exacerbated by claims trading. Claims traders often seek influence in a reorganization case, but often their goal is not repayment of amounts they loaned to the debtor. Their motivation typically includes a better return on their investment in the claims they have purchased or ownership of the debtor upon its emergence from the reorganization case (a loan-to-own strategy). Such a motivation is not necessarily representative of the general body of unsecured creditors. Moreover, as traders, they may either add to their position during the case or exit their position and resign from the committee. It is the practice of the Office of the United States Trustee, which selects creditors for the committee, to require that committee members refrain from trading while they serve on a committee. The effect concentrates control in those who became creditors, either by advancing credit or by purchasing claims, before the reorganization case is opened and who have a continuing interest in the reorganization's outcome and in overall recoveries, rather than in those whose only interest is in return on a claims investment during the case. But it excludes those who become creditors after the case is opened and yet intend to hold their positions until final recoveries in the case, whether in cash or by acquisition of equity in the reorganized company, and therefore have as much interest in the outcome as original creditors. As with many areas in the reform effort, claims trading has a material effect on the process.

2.4. Monitor, Supervisor, Facilitator

As an alternative, some have suggested the appointment of an official who would assume some control over the process. In 2001, the American Bar Association Select Advisory Committee on Business Reorganization (SABRE) recommended the appointment of a neutral facilitator to foster consensus. If the negotiations did not produce a plan, the court could then permit the facilitator to file a plan. *First Report Of The Select Advisory Committee On Business Reorganization*, Karen M. Gebbia-Pinetti, Reporter, 57 BUS. LAW. 163 (2001). This alternative would add a player to the process, rather than replace any of the existing players, though the facilitator's role would possibly substitute for some of the court's management and control of the reorganization process. The proposal has gained little traction, getting only one citation in the literature in ten years. Michelle M. Harner, *The Search For An Unbiased Fiduciary In Corporate Reorganizations*, 86 NOTRE DAME L. REV. 469 (2011). *See* Kit Weitnauer, *Should an Examiner Prosecute Claims? A Response to Proposed Changes to the Role of Examiner Contained in the Second Report of SABRE*, http://www.abiworld.org/AM/Template.cfm?Section=Home&Template=/MembersOnly.cfm&ContentID=40245&FusePreview=False (last visited April 29, 2012) (challenging SABRE's recommendation that an examiner should be authorized to prosecute claims on behalf of the estate).

It should not be surprising that the idea has gained little support. American reorganization jurisprudence, based on the common law, is based on parties protecting their own interests and allowing them full-throated rights to prosecute their claims. Moreover, as a financial matter, creditors prefer to control their own destiny. They do not prefer placing the outcome of a reorganization case and their recoveries in the hands of a neutral facilitator or monitor, however balanced and well-intentioned.

2.5. Conclusion

The self-administration model is likely to survive, and the restrictions on a debtor in possession are likely to continue to come from the private sector, rather than from a government-appointed fiduciary. However, the roles are likely to be rebalanced to take account of the appropriate interests of each class of creditors in protecting their own positions while respecting the rights of other classes. The re-balancing will be a delicate operation. As in the past, it will undoubtedly require further re-balancing as experienced practitioners gain and exercise a better understanding of the leverage that their positions give them.

3. Debtor in Possession Financing ("DIP Financing")

A chapter 11 debtor's ability to obtain DIP financing and/or use cash collateral is a crucial element in providing a debtor an opportunity to develop alternative strategies to maximize enterprise value for the benefit of all stakeholders.[4] Although the Bankruptcy Code contains numerous protections and incentives to encourage lenders to provide postpetition financing, the Bankruptcy Code provides few checks on lenders overreaching and exerting leverage to drive the chapter 11 process, often to the detriment of the estate and the debtor's other stakeholders. Due to the prevalence of companies granting lenders blanket liens over all their assets, prepetition secured lenders more often than not end up being the only lenders willing to provide postpetition financing to debtors. Postpetition financing proposals often come with onerous terms that result in the debtor losing the ability to control the course of the chapter 11 case and providing lenders with benefits they would not otherwise be entitled to outside of chapter 11. It is this "creditor-in-possession" phenomenon that has contributed to a proliferation of quick sales under section 363 of the Bankruptcy Code.

Although lenders should have incentives to provide postpetition financing, that must be balanced against the restructuring objectives of debtors and their stakeholders. This section of this paper outlines some of the recurring issues that surface in DIP financings and use of cash collateral orders and sets forth proposals for addressing these issues. As reflected below, each of the proposals is aimed at balancing the goals of affording a debtor a fair chance to reorganize while being fair to the postpetition lenders and other secured creditors. In addition, many of the below proposals prohibit outright certain provisions in DIP financing orders and cash collateral orders (collectively, "**Financing Orders**") that are already disfavored by courts so that courts will not be placed in the difficult position of being forced to approve these provisions just to avoid the debtor losing its only source of postpetition financing. Anecdotal evidence shows that prohibiting these provisions outright should not negatively affect a debtor's ability to obtain postpetition financing.

3.1. Forced Asset Sales

To avoid the risk of diminution in value of their collateral, secured lenders frequently prefer quick sales of substantially all of the debtor's assets to a prolonged chapter 11 case. Financing Orders increasingly contain deadlines for debtors to conduct section 363 sales of substantially all of their assets, often within a few weeks after the filing of a chapter 11 case. Such forced asset sales may preclude a debtor from formulating alternative business plans. The estate may also receive lower values from such sales than if the debtor had more time to solicit bids or prospective purchasers had more time to conduct due diligence.

> ***Proposal:*** Set a minimum amount of time prior to which a hearing on the sale of substantially all of the debtor's assets cannot be set in a Financing Order (e.g., 180 days after petition date) (the "**Sale Threshold**"). In addition, to foreclose the possibility that a lender will attempt to circumvent the Sale Threshold by setting a quick maturity date,

[4] This is consistent with the United States Supreme Court's observation that the "fundamental purpose of reorganization is to prevent a debtor from going into liquidation . . . ." *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 528, 104 S. Ct. 1188, 1197 (1984).

(i) establish a minimum maturity date for DIP loans that mirrors the Sale Threshold, and

(ii) provide that DIP loans cannot mature or accelerate simply on account of the sale not closing within 60 days after of the order approving the sale. Establishment of these thresholds should not disadvantage lenders because they will still have the ability to set financial and performance driven covenants designed to protect the lender from deterioration in collateral coverage. They will also still be able to seek to lift the automatic stay to pursue state law remedies. In the event a sale of substantially all of the assets is necessary in a melting ice cube or emergency situation, the Debtors would retain the ability to ask the Court to set a hearing on such sale before the Sale Threshold.

3.2. Control of Chapter 11 Case Through Use of Milestones

Similarly, lenders increasingly try to control the speed and direction of chapter 11 cases through use of milestones in financing documents, such as deadlines for filing chapter 11 plans, confirming chapter 11 plans, and limits on debtors' exclusive periods to file and solicit acceptances of a chapter 11 plan. Failure to comply with these deadlines is usually an event of default under the documents.

> ***Proposal:*** Prohibit Financing Orders from limiting any of the statutory rights granted to debtors by the Bankruptcy Code, such as the exclusive periods to file and solicit acceptances of a plan. Lenders may object to the proposed extension of exclusive periods or request milestones as a condition to granting any such extension. Courts already condition extensions of exclusive periods in certain cases on achievement of various milestones. Financial covenants would continue to protect DIP lenders from changes in the debtor's ability to satisfy its obligations under the DIP financing agreement.

3.3. Roll-Up Provisions

Increasingly, DIP lenders require that debtors use DIP financing to "roll-up" their prepetition secured debt to postpetition status, often at higher interest rates and while providing little new financing (*e.g., in* the *Circuit City* chapter 11 case). The effect of a roll-up is to require a debtor to satisfy the rolled-up debt as an administrative claim under the chapter 11 plan, rather than as a secured claim that can be crammed down. This is especially problematic when the DIP lenders are a group consisting of multiple lenders. Absent a negotiated alternative in the Financing Order, the lenders may take a position that as an administrative claim, 100% lender consent would be required to agree to accept anything other than full cash payment of such claim under a plan. By requiring their prepetition debt to be rolled-up, DIP lenders thus exercise control over the chapter 11 process and limit the debtor's reorganization options.

> ***Proposal:*** Prohibit all roll-ups, except to the extent (i) the collateral constitutes receivables and/or inventory, (ii) the rolled-up debt provides incremental liquidity to the debtor and is in the best interests of the debtor's estate, and (iii) the amount of the rolled-up debt is limited to the value of the prepetition collateral collected. Such rolled-up debt should be classified in a separate administrative claim class, be subject to the acceptance requirements of section 1126(c) (so that only 2/3 in amount and 1/2 in number of the voting lenders are needed to accept the plan), and be payable in cash or other consideration, but not be subject to potential cramdown under section 1129(b) of the Bankruptcy Code.

3.4. Cross-Collateralization

Forward cross-collateralization enables a lender to secure prepetition debt with postpetition collateral. A lender is thereby able to improve its prepetition position in chapter 11, to the detriment of other creditors.

> ***Proposal:*** Prohibit forward cross-collateralization other than for use as adequate protection, *i.e.*, to the extent of diminution in the lender's interest in the collateral.

3.5. Lack of Competition for DIP Financing

There is very limited competition for DIP financing for a variety of reasons, including difficulty priming prepetition secured lenders. In addition, once initial DIP financing is obtained, usually through the prepetition secured lenders, there is difficulty in obtaining take-out DIP financing because (i) the "rolled-up" debt necessitates a new DIP lender to take out the "rolled-up" debt as well as the new funds that are advanced, thereby increasing the amount of funds necessary to accomplish a take-out of an existing DIP lender, and (ii) prepayment penalties in DIP financing agreements would also have to be paid. Greater competition for DIP financing will help lower the cost of postpetition financing for debtors and help reduce the abuses discussed herein that have become common with postpetition financing.

> ***Proposal:*** To enhance the prospects for take-out DIPs, the following should apply: (i) prohibit approval of roll-up provisions except under the conditions set forth above (see Proposal for 3.3), (ii) limit interim DIP financing approval to funds necessary to operate the debtor during the interim period, (iii) prohibit prepayment or similar penalties in DIP financing agreements during the interim period, and (iv) require that DIP loans not unduly restrict a debtor's ability to refinance a DIP loan, including, without limitation, not precluding the debtor from incurring reasonable expenses to encourage competitive DIP bidding.

3.6. Liens/Claims on Causes of Action

DIP lenders typically request liens on chapter 5 avoiding power causes of action (*e.g.*, preferences and fraudulent transfers) and superpriority claims payable from proceeds of such actions. DIP lenders also request liens on collateral that is freed as a result of lien avoidance actions under section 724. Because courts, trustees and creditors' committees think these causes of action are an important source of recovery for unsecured creditors, courts disfavor granting liens to DIP lenders on these causes of action. DIP lenders argue, however, that because proceeds of chapter 5 causes of action and the collateral that is freed by section 724 causes of action are property of the estate, in the event there is insufficient cash to repay a DIP loan, proceeds from such causes of action should be used to pay off the DIP loan.

Proposal: Consider one of the following two approaches:

> ***Option A:*** Prohibit Financing Orders from granting DIP Lenders liens and superpriority claims on chapter 5 (other than claims under section 549 of the Bankruptcy Code, unless the DIP Lender is complicit in the transfer) and section 724 causes of action, including proceeds thereof; or
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> ***Option B:*** Prohibit Financing Orders from granting DIP Lenders liens on chapter 5 and section 724 causes of action, but give courts discretion, under appropriate circumstances, to (i) allow DIP Lenders' liens to be satisfied from proceeds of chapter 5 or section 724 causes of action (other than from proceeds of such causes of action against the DIP Lender itself, its directly or indirectly wholly-owned subsidiary, or any affiliate that directly or indirectly wholly-owns the DIP Lender), and (ii) allow DIP Lenders that extend new loans postpetition to secure such loans by liens on collateral that is freed by avoidance of liens pursuant to chapter 5 or section 724, unless such avoidance actions were against the DIP Lender itself, its directly or indirectly wholly-owned subsidiary, or any affiliate that directly or indirectly wholly-owns the DIP Lender. This approach would allow the debtor or trustee and, in certain circumstances, the creditors' committee, to control the chapter 5 and section 724 causes of action, while permitting DIP Lenders to seek a lien or super-priority claim in the proceeds of such causes of action.

3.7. Control of Management

It has become increasingly common for lenders to condition postpetition financing on appointment of a chief restructuring officer ("**CRO**") who must be acceptable to the lender. For example, in *Pilgrim's Pride*, the debtor in possession covenanted that it would at all times while the DIP loan was outstanding have a CRO who was reasonably acceptable to the lender and whose scope and authority were reasonably acceptable to the lender. Failure to comply with the covenant constituted an event of default. In *LandSource Communities Development,* the DIP financing agreement provided that the CRO would be appointed to a one-member executive committee of the company if one of the borrowers requested an extension of the plan exclusivity periods without the agent's consent and without meeting certain requirements.

This power to select or appoint management is a deviation from corporate governance outside of chapter 11, where lenders do not select or appoint management, and may impair management's ability to operate the chapter 11 case for the benefit of all stakeholders, not just the senior lender. The selection of a CRO, if any, is typically something that is resolved before the DIP financing motion is filed, with the CRO selection being made by the debtor frequently with the lenders' nod. Although changes to financing rules may not change this practice, imposing certain limits on Financing Orders may help curb the more aggressive lender controls over management appointments.

Proposal: Prohibit Financing Orders and related agreements from containing:

(i) provisions requiring the appointment of management or a CRO if a debtor does not meet certain deadlines that by statute or court order it may have a longer time to meet, such as the exclusive period to file and solicit acceptances of a plan, or

(ii) provisions dictating the authority or scope of a CRO's duties or requiring lender consent to same; except that Financing Orders could condition the financing upon a CRO being selected by the debtor in possession that is reasonably acceptable to the DIP lender.

All creditors may already be heard on a motion to approve the engagement of a CRO, which includes the scope of authority.

3.8. Impairment of Unsecured Creditor Rights

As a condition to postpetition financing, lenders often require debtors in possession to waive (i) rights to surcharge collateral under sections 506(c) and 552(b) of the Bankruptcy Code and (ii) the ability to seek non-consensual use of cash collateral later in the chapter 11 case. In addition, lenders typically request that the court make findings (or that the debtor in possession stipulate) in the Financing Orders that their prepetition liens are valid. Debtors should not be asked to waive rights granted to them by the Bankruptcy Code (such as rights under sections 506(c) and 552(b) and the right to seek non-consensual use of cash collateral) just to obtain postpetition financing, and courts are usually hesitant to do so. With respect to findings that the lenders' prepetition liens are valid, although it may be reasonable for debtors in possession to agree to these provisions to obtain postpetition financing, such provisions are usually prejudicial to unsecured creditors, who are not involved in negotiating the initial postpetition financing agreements and have not had the opportunity to investigate the liens. As a result, it has become customary for the unsecured creditors' committee, once formed, to negotiate with DIP lenders to try to obtain carve-outs from these provisions.

Proposal:

- Prohibit waivers in interim and final Financing Orders of section 506(c) rights;

- Prohibit waivers in interim Financing Orders of the right to seek non-consensual use of cash collateral;

- Prohibit waivers in interim and final cash collateral orders of the right to seek non-consensual use of cash collateral after expiration, under the terms of such cash collateral orders, of the use of cash collateral;

- Amend Bankruptcy Rule 4001(b)(2) and (c)(2) to provide that final hearings on the use of cash collateral or DIP financing may not be held earlier than 30 days after entry of the interim Financing Order, but upon request of the debtor in possession, the court may conduct a final hearing before such time period (but in no event earlier than 14 days after entry of the interim Financing Order) if the creditors' committee has consented; and

- Prohibit waivers of section 552(b) rights or provide that the waiver of these rights is effective only as against the debtor in possession and not against the unsecured creditors' committee. Under either alternative, the unsecured creditors' committee may investigate whether the lenders' prepetition liens are valid. Allow the use of postpetition financing for such investigation, within limits set forth in Financing Orders based on the circumstances of the case. Codify factors or establish guidelines that should be relevant in determining whether circumstances of the case justify the applicable limits set forth in the Financing Orders, including, without limitation, (i) whether a plan needs to be confirmed quickly, (ii) whether general unsecured creditors will benefit from an investigation of prepetition secured lenders' liens, and (iii) whether the debtor has already conducted an investigation into the liens (consider requiring the debtor in possession to share the results of the investigation with the unsecured creditors' committee).

4. Sale of All or Substantially All of the Debtor's Assets

Going-concern sales and reorganizations are two different ways to sort out the affairs of a financially distressed business. In some instances the best path is a sale to a new owner. In other instances, it will be a recapitalization. Unfortunately, the United States 1978 Bankruptcy Code was not written with the idea that sales could be an effective alternative to reorganization in many cases. The procedures it sets out for a sale under § 363(b) are underdeveloped and subject to abuse. A sensible reform of the Bankruptcy Code would both put procedural protections in place and at the same time minimize the incentives of parties with control to choose sale or reorganization on the basis of what advances their individual interests, rather than the interests of everyone as a group.

The Bankruptcy Code was also written at a time when unsecured debt was the fulcrum security in the typical case. Many parts of the Bankruptcy Code, from the treatment of administrative expenses to the committee structure, were written with this assumption in mind. In today's large chapter 11 cases, the secured creditors are often the only ones in the money. Some scholars believe that it should not be troubling that the typical beneficiaries of bankruptcy will be secured creditors. To them, there is no great conceptual difference between a firm that has a capital structure with ordinary debt and subordinated debt; a firm that has a capital structure with secured and unsecured debt; and a firm with senior secured and junior secured debt. Equity receiverships commonly consisted of multiple tiers of secured debt. Other commentators would balk at a bankruptcy system designed solely (or primarily) to serve secured debt. Why should taxpayers fund a bankruptcy system for the benefit of creditors who seek to enforce their lien rights? There is no common pool problem to be addressed. Regardless of the philosophy, the rise of secured debt may require changes in the Bankruptcy Code, because the Code was written under the assumption that the unsecured creditors would typically hold the fulcrum security.

The precise shape of the capital structure should not affect the choice of whether to sell or reorganize the firm. Choosing between sale and reorganization requires asking which yields the largest pie for distribution to whoever is entitled to receive it. It has nothing to do with how the pie is sliced or whether any of those entitled to a slice are secured.

The differences between Bankruptcy Code sections 363(b) and 1129 come primarily from two sources. First, section 363 is tremendously underdeveloped. It contains no protections or standards as to how the sale should be conducted. Beyond the right to notice and a hearing, there are no procedures comparable to those in chapter 11, and especially section 1129, to protect dissenting parties. Second, and analytically different, section 363 is focused entirely on the sale itself and not on who gets what. In contrast to section 1129, it does not touch the issue of how the proceeds will be distributed or how anything will be paid.

Accepting the importance of a sale as an independent way of restructuring firms requires more than simply folding going-concern sales into the existing plan confirmation process. There need to be procedures focusing on the sale itself. The existing provisions of chapter 11 do not do this as they are designed under the assumption that the ultimate backstop is a judicial valuation rather than a market sale. That said, the relative distributional outcomes should not change depending upon which avenue is chosen. Where there is overlap between the rules put in place in section 363 and the traditional reorganization process, they should track each other. The different wording in Bankruptcy Code section 363(f) and section 1141 invites unnecessary difficulties. The scope of the discharge, for example, should be constant, regardless of whether there is a sale. The ability to reshape collective bargaining agreements should similarly be the same, regardless of which avenue is used.

A reshaped Bankruptcy Code that expressly contemplated going-concern sales should confront several issues on which section 363 is silent. Section 363 says nothing about what standard should be used to decide whether or how a sale should be conducted. It is conspicuously silent about, among other things, whether and to what extent noncash bids can be accepted. There are no time periods comparable to the ones in section 1121 to provide presumptions as to how much notice must be given or when and under what circumstances someone else can propose a sale. Moreover, there is nothing comparable to the "best interests of the creditors" test under section 1129(a)(7) to protect dissenting creditors. Section 363 is also silent as to how the sale is to be paid for. There is nothing comparable to Bankruptcy Code section 1129(a)(9)(A).

Traditional reorganizations work with classification and voting rules that give greater rights of review when those similarly situated oppose a plan. Section 363 provides no such enhanced powers. That said, it is not obvious that there should be. These provisions may be necessary in a traditional reorganization precisely because there is no market sale and instead an expensive judicial valuation. The question whether a sale can be done effectively may be a binary one. If it can be done effectively, it should bind everyone. If it cannot be, arguably it should not take place at all. In the sale context, creditor voting is simply unnecessary. Moreover, with developments in the derivatives markets and the advent of credit default swaps, it is time to question whether majority creditor voting should be retained as an element of chapter 11 plan confirmation even when a sale is not involved.

Section 363 provides for no distributional rules. Once the proceeds are collected, the implicit assumption is that whatever is received will be distributed later under a plan or in a liquidation. There are, however, several ways in which distributional consequences still follow in the wake of a section 363 sale. First, whenever a court allows credit-bidding (that is, allowing a bidding secured lender to offset its secured claim against the purchase price), it is making some assessment as to the validity of the lien. Whenever the lien covers only part (even if it is the major part) of the firm, one is making implicit decisions about distribution. In addition, parties to the sale may try to include amounts to be paid to prepetition creditors in an order entered in conjunction with the sale.

Parties can also couple the sale order with a motion to convert to Chapter 7, which again has distributional consequences.

The amount of oversight a sale requires depends in some measure on the circumstances. A situation in which the senior lender who is owed $500 presses for a sale of everything for $100 is in this respect much easier that one in which the senior lender is owed $100 and is pressing for a sale for $100. In the first case, there is strong reason to believe that only the senior lender is in the money. If money is being left on the table, it is the money of the senior lender. We do not need to scrutinize the sale as much because if it is a bad idea, the senior lender is the one bearing the consequences. By contrast, we need to worry that if the results of a quick sale is coming very close to paying the senior lender in full, we have a fire sale that is not maximizing value. We need to worry in a similar fashion if the sale is one in which the senior lender is going to end up with the business or when insiders are the stalking horse bidders.

With this in mind, it is time to consider a few ideas about how we might rework sections 363(b) and 363(f) of the Bankruptcy Code.

4.1. What is the relevant test for approval of a sale—*Lionel* or something else

In re Lionel Corp., 722 F.2d 1063 (2d Cir. 1983), permitted a sale of all or substantially all of the assets of the estate upon a showing that there was a good business reason for the sale. Should this remain the test for approving a sale, or should the test be something else?

In short, we answer this question "something else." In deciding whether to approve a sale under section 363(b), the bankruptcy judge should not defer to the business judgment of the debtor. Rather, the bankruptcy judge should make an independent assessment whether the proposed sale is the course that maximizes the value of whatever is being sold for the benefit of the estate. The burden of proof should remain on the proponent of the sale. Although the proponent need not show that the business or assets are "melting" to justify the sale, the proponent would have to demonstrate that a sale of the business or assets—in the time frame proposed and in the manner proposed—is the most sensible course.

This is a stronger standard than *Lionel*, as the sale proponent has to do more than show that there is a sensible business reason for the sale. The proponent must affirmatively demonstrate that a sale, in the time frame proposed and in the manner proposed, is a good idea for all concerned, that is, it is in the best interest of the estate.

The benchmark for testing the reasonableness of the manner proposed for the sale should be that the sale is being conducted in a fashion that is consistent with the way a prudent person would do it if trading on his own account. If a seller would take some period of time searching for a buyer outside of bankruptcy, a similar amount of time should be presumptively expected inside. Of course, the court can and should consider efforts made before the bankruptcy filing to market the assets. And, if those efforts were prudent, the postpetition requirements for further marketing, etc. can be modified accordingly.

4.2. When can the sale occur—i.e., what timing is appropriate

Although an outright prohibition of sales for a defined period of time might facilitate the debtor (and creditors) having the opportunity to meaningfully evaluate the prospects for a true reorganization of the debtor's business, an absolute prohibition of a sale is problematic. Certainly, if the asset is a melting ice cube, a sale before it completely melts is both appropriate and necessary. However, in today's environment, secured creditors with blanket liens often "force" a quick sale of the debtor's assets by refusing to lend monies other than those necessary to operate while a short sale process plays out.

We propose a higher burden of proof during the early stages of a chapter 11 case. No sale can occur during the first 60 days of the bankruptcy case, unless the proponent of the sale can demonstrate by clear and convincing evidence that the bankruptcy estate will suffer an irreparable injury if there is no sale. After that, the burden of proof in connection with a sale motion would return to the lesser preponderance of the evidence standard.

This would have the effect of limiting rapid sales, particularly of substantially all of the debtor's assets. The idea is to retain flexibility, but to make the sale process more akin to the plan confirmation process.

4.3. Who pays for the bankruptcy process in the context of a sale of substantially all of the debtor's assets?

Those who benefit from the bankruptcy process should pay for it. Existing law places expenses after the claims of secured creditors, but this is a consequence of the Bankruptcy Code's assumption that the unsecured creditors would most often be "in the money". Now that this assumption no longer holds, this rule needs to be changed substantially. Given the existence of Bankruptcy Code §506(c), this should not be regarded as a dramatic change, but §506(c) in its current form is too narrow.

The expenses of the sale should be deducted off the top from the gross proceeds of the sale. See U.C.C. § 9-615(a)(1). These expenses do not correspond perfectly with the administrative expenses under Bankruptcy Code section 503(b). For example, they would not include expenses for prepetition goods under Bankruptcy Code section 503(b)(9). At a minimum, however, the cost of running the business while the sale of substantially all of the debtor's assets is being organized and consummated should be chargeable against the sale proceeds, as these expenses are charged against property when it is sold outside of bankruptcy.

Moreover, the reasonable costs associated with running the bankruptcy case pending consummation of a sale should be chargeable against the proceeds of the sale. In those cases when the U.S. Trustee is successful in forming a creditor's committee in the case, the reasonable fees and expenses of the Committee and its professionals in connection with the case and the sale should be paid from the sale proceeds.

Although the secured creditor should enjoy the right to credit bid, he should nevertheless have to put up sufficient cash to pay the costs of a bankruptcy sale. These expenses may be fixed in advance in the same fashion as carve outs, including, for example, a budget for the debtor in possession's and the creditors' committee's professional fees and a cap on the amount that the creditors' committee can expend on investigating the liens of the senior creditor.

If the secured creditor does not want to pay for the costs of a bankruptcy process, it has other remedies—*i.e.*, relief from the automatic stay; dismissal of the bankruptcy case; and, ultimately, its state law remedies—it can foreclose on its collateral and then dispose of the assets as it sees fit for its own account. The sometimes current practice of allowing a sale to go forward and then immediately allowing a conversion to Chapter 7 and leaving expenses associated with the sale unpaid should not be permitted.

4.4. Sale Process vs. Distribution Process

The sale itself should be conducted in a way that separates the sale process from the process that decides how the proceeds of the sale are divided up. This seems to be the basic idea at work in *In re Braniff Airways, Inc.* 700 F.2d 935 (5th Cir. 1983). *See also In re Continental Air Lines, Inc.* 780 F.2d 1223 (5th Cir. 1986). There should be a prohibition on the sale order's specifying any particular distribution of the proceeds or resolving such questions as avoidance actions. That should be left to a later motion or other procedural device.

Equally important, the sale procedures and the definitions of qualified bids should not limit the coin in which bids are made. Among other things, a bidder should always be able to make a straight cash bid and take the assets without being subjected to any limitations as to how the business should be run or what existing obligations need to be assumed.

4.5. Sales free and clear of what?

The sale mechanism should be set up in a way to maximize the proceeds received. To the extent existing law is not clear, Bankruptcy Code section 363(f) should be revised to make it plain that a sale of assets can be done free and clear of liens, claims, and interests and be every bit as unencumbered as they would be if the firm were reorganized and there was a discharge under section 1141. *See In re Trans World Airlines,* 322 F.3d 283 (3d Cir. 2003). The addition of "claims" to the "free-and-clear" language of §363(f) may be sensible, as it has led some courts to draw inferences from its absence. *See, e.g., Volvo White Truck Corp. v. Chambersburg Beverage, Inc. (In re White Motor Credit Corp.)*, 75 B.R. 944, 948 (Bankr. N.D. Ohio 1987) ("[g]eneral unsecured claimants including tort claimants, have no specific interest in a debtor's property" for purposes of section 363(f)). In addition, the difficulties some courts have experienced in interpreting the interaction between sections 363(f)(3) and (f)(5) should be addressed. *See, e.g., Clear Channel Outdoor, Inc. v. Knupfer (In re PW, LLC)*, 391 B.R. 25 (9th Cir. BAP 2008). Specifically, an underwater junior lien should not be able to block a sale free and clear of its interest by withholding its consent.

Again, the choice between confirmation of a plan and a sale of substantially all of the debtor's assets by motion should be based on what is best for the estate, subject to the constraints of due process and the like. There is no need to distinguish between the two. Regardless of whether the sale yields enough to pay off junior lienholders, the sale should be free and clear of their interest. This is the law outside of bankruptcy and there is no reason to have a different principle at work inside.

4.6. Protection of good faith purchasers

Bankruptcy Code section 363(m) should be retained. Good faith purchasers should be protected in the event the sale is consummated, and no stay of the sale was obtained.

4.7. Collusion among bidders

Similarly, Bankruptcy Code section 363(n) should be retained. It protects the estate from collusive bidding. Auctions work effectively only if bidders do not collude with one another. However, under certain circumstances, a coalition of two bidders may be willing to make a higher bid than either one separately or any other bidder. Prohibitions against collusion should not prevent potential buyers from joining forces when such a course would be in the estate's interest. Disclosure may provide the most sensible path to ensuring this outcome. Accordingly, there should be no per se prohibition on contacts or discussions among potential bidders, but such contacts or discussions that do take place must be disclosed. With such a rule in place, parties would be more likely to engage only in those discussions that they are willing to talk about in open court.

5. Plans

As the goal of a reorganization case and as the document by which the debtor's value is distributed to stakeholders, there are numerous reform issues related to both the procedural protections associated with a plan's negotiation, solicitation, and confirmation and to the substantive distributional protections provided to both senior and junior creditors and equity holders. This paper focuses only on the procedural issue of voting and the distributional issue of treatment of secured claims and equity interests.

5.1. Plan Voting (Conflicts Of Interest: Extraneous Interests, Conflicting Holdings, Hedging)

The Bankruptcy Code's plan voting scheme was developed when creditors and shareholders who voted on a plan usually were the originally holders of claims and interests (other than ordinary trading of publicly issued debt and equity), and the holders generally held claims only in one class. Holders of similar claims or interests generally had the same economic interests, so it was appropriate to group them together in classes and take the vote on the plan by class.

Thus, the Bankruptcy Code closely ties voting, classification, and distributional rules. The distributional rules protect each class of claims or interests by minimum distribution standards depending on whether the class accepts the plan. Voting rules determine the protection to which holders in a class are entitled. The holders of claims in a class that accepts the plan must receive at least the recovery they would receive in a liquidation case. 11 U.S.C. § 1129(a)(7). The holders of claims in a class that does not accept the plan must receive the full amount that they would receive under a plan that complied with the absolute priority rule; that is, they are entitled to full recovery before holders in any junior class receive any recovery. 11 U.S.C. § 1129(b). Accordingly, existing classification rules require similarity among claims or interests placed in a class. 11 U.S.C. § 1122(a).

When a claim or interest holder holds multiple claims or interests of different kinds, has purchased the claim or interest at a substantial discount, or has participated out or hedged the claim, whether or not with a transfer of voting rights, it is far from clear that the holder's interests will align with the interests of other holders of similar claims. For example, in the chapter 11 reorganization case of Adelphia Communications, certain holders of bonds issued by the parent company and by a subsidiary were alleged to oppose the parent company's plan to enhance their recovery at the subsidiary. The court found that such a conflict, even if proven, would not be sufficient to disqualify the holders' votes against the parent's plan. *In re Adelphia Comm'ns Corp.*, 359 B.R. 54 (Bankr.

S.D.N.Y. 2006). Therefore, the premise of the existing classification and voting system can break down, and a new system should be considered.

Current proposals for reform suggest a revision of the voting system (rather than of the classification or distribution systems) to weed out votes of holders who hold conflicting interests. Such a system would require each holder to disclose all economic interests in addition to the claim and any voting agreements, such as under a participation agreement. Such extensive disclosure could be intrusive and would be resisted by creditors who trade and carefully guard against public disclosure of their holdings. Similar resistance was encountered when the Advisory Committee on Bankruptcy Rules proposed a change in the general committee disclosure rule in chapter 11 cases, Rule 2019 of the Federal Rules of Bankruptcy Procedure, and the Committee adopted a modification of its initial proposal. http://www.uscourts.gov/uscourts/RulesAndPolicies/rules/Supreme%20Court%202011/BK_Report.pdf, at 3-7, 31-32 (last viewed May 5, 2012). The modified Rule became effective in December 2010. http://www.supremecourt.gov/orders/courtorders/frbk11.pdf (last viewed May 5, 2012). The disclosure is limited to groups of creditors who make an actual appearance in the case in court. Full disclosure of all economic positions held by all voting creditors, even on a confidential basis, would be a entirely different undertaking, and analysis of the data to determine voting conflicts could be even more daunting a task.

An alternative would be to return to the practice under former Chapter X of the Bankruptcy Act. There, the court had to make an independent determination of the plan's fairness to creditors and shareholders. Although creditors and shareholders voted, their acceptance or rejection of the plan did not determine the standard the court was required to apply. Bankruptcy Act § 221(2), repealed effective Oct. 1, 1979, Pub. L. 95-595, § 401(a), 95 Stat. 2682 (1978); *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 114 (1939). Such a proposal undermines a core principle of the Bankruptcy Code, which is that the parties with interests at stake should determine their own fate. H.R. Rep. No. 95-598, at 224 (1977). That principle is not likely to change.

Clearly, more work needs to be done in this area. As with governance, a re-balancing will be required.

5.2. Plan distribution (absolute priority, pervasive security interests, class-skipping transfers)

5.2.1. Conversion of Debt to Equity Without Shareholder Consent

Conversion of debt to equity will remain a key part of the system. It has long been a principle of U.S. jurisprudence that upon a corporation's becoming insolvent, creditors become the equitable owners of the corporation. *See Northern Pacific Ry. Co. v. Boyd*, 228 U.S. 482 (1913); *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). The idea is too thoroughly embedded to be considered for change. The Bankruptcy Code provides a means to effect the formal legal transfer of ownership, and some state laws expressly recognize the Code's effect, despite non-bankruptcy rights of shareholders. *See* Del. Gen. Corp. Law, 8 Del. Code 1953 § 303 (corporation may take corporate action that is authorized by a bankruptcy court order without director or shareholder vote).

Moreover, the ability to convert debt to equity in an insolvency proceeding without shareholder approval serves an important function in the capital markets. With the ease of trading in claims against a distressed enterprise, many distressed investors acquire large positions in claims with a view to converting their debt to equity in a reorganized company. The ability to do so in an insolvency proceeding facilitates the claims trading market, which may be a more efficient way for a distressed company to transfer control of itself as a going concern than an auction process. The auction process brings its own dislocations to the company and its operations, both during the process and in the transition of the company to its new owner. Moreover, permitting the transfer of control through the claims trading market allows each creditor to determine the price at which it is willing to exit or to remain in the capital structure to obtain the new equity.

The claims trading model is not without its problems. It could be argued that the auction process results in better recoveries for creditors and is a fairer process that is less susceptible to manipulation by aggressive and sharp trading practices. In any event, the merits of claims trading as a means to provide creditors a liquid exit route and to transfer control is a separate issue from the merits of debt to equity conversion, which facilitates the claims trading market and, for whatever reason, is not likely to be revisited in any reform effort.

The distributional issue instead will focus more on the treatment of secured debt, whether in a sale or in a plan and on the treatment of trade claims and claims arising under executory contracts and unexpired leases.

5.2.2. Treatment of Secured Debt

There are three principal reasons for the protection of secured debt in a U.S. reorganization case: economic, political and constitutional. There is a widely-held belief that the protection of secured debt results in cheaper or greater credit availability. *See* Julia M. Whitehead, *Viewpoint: Repo Rides Again*, DOWJONES DAILY BANKR. REV., http://bankruptcynews.dowjones.com/article?an=DJFDBR0020120502e852rak07&from=NL&pid=10, May 2, 2012 (last viewed May 5, 2012) (2005 bankruptcy amendments to protect mortgage securities repos increased mortgage lending in the mid-2000's). Some question whether the belief is accurate, because there is little empirical evidence to support it. Others question whether cheap, unlimited secured credit is actually a boon or a bane. They point to the mortgage bubble and LBO financing in 2006-08 as examples. *Id.* Neither ended well.

The political dimension plays a major role in the debate, putting a thumb on the scale in favor of protecting secured debt. Secured lenders have powerful political voices, both in terms of their importance in their communities and their lobbying efforts and campaign contributions. [Citation?]

Finally, the U.S. Constitution prohibits the taking of property for a public purpose without just compensation and protects against deprivation of property without due process of law. U.S. CONST. AMEND. V. The U.S. Supreme Court has ruled that a lien such as a security interest is a property right and that failure to provide a secured lender with the value of its collateral violates the Constitution. *Louisville Joint Stock Land Bank v. Radford*, 295 U.S. 555 (1935). The Court has not specified the minimum valuation method but has suggested that protection of liquidation value is adequate. The Court has ruled in other contexts that a change that applies only prospectively would not violate the Constitution. *See Sec. Indus. Bank v. U.S.*, 459 U.S. 70 (1982). So prospective change could be permissible, perhaps subject to the ability of lenders to amend and extend existing liens indefinitely to evade new requirements.

Thus, there are major challenges to reforming the treatment of secured debt in restructuring cases. Current ideas under discussion are limited to ensuring that in a chapter 11 case in which the only (or principal) beneficiaries are secured lenders, the secured lenders are charged with the entire cost of administration, including the costs of operating the business as well as the cost of the professionals who administer the reorganization case itself and ensure that the treatment in the case of other constituencies complies with statutory protections. As noted, any proposal that is materially more aggressive, such as a 10% surcharge on collateral for the benefit of other economic interests in the case, even if politically feasible, might apply only to new loans. So the effective transition period to the new system would be especially prolonged, as lenders presumably would restructure transactions to "amend and extend" existing loans and security interests rather than characterize them as new loans. Unless the reform legislation successfully treats these efforts as new loans, the result in cases in which a secured lender has an undersecured pervasive security interest will be to prevent any recovery by junior secured, unsecured or equity classes, which will largely permit the secured lender to dictate the result, subject to disputes over valuation and whether the secured lender is undersecured.

5.2.3. Treatment of Trade Claims and Contract Counterparty Claims

The secured lender's recovery in such a situation is also subject to the ability of trade creditors and contract counterparties to extract value by leveraging their positions as essential suppliers to the reorganized (or acquired) entity. That ability affects distribution more by economic forces in a particular case than by legal priorities or requirements. Legal rules may limit the ability, but possibly at the expense of the value of the reorganized entity, to the extent that suppliers refuse to deal on current market or contract terms, whichever is more favorable to the reorganized entity.

Currently, a counterparty to a contract (including a lease) is entitled to complete cure of economic defaults as a condition to being required to abide by the contract terms. 11 U.S.C. § 365(b). This rule provides a contract counterparty a priority in the reorganization process. As a result, lawyers and courts have spilled much ink on whether a particular relationship qualifies for treatment as a contract that is entitled to priority treatment. Reform efforts are starting to re-examine the justification for the priority. For example, should there be a distinction between contracts that are, from the counterparty's perspective, active or passive, that is, requiring continued affirmative performance or requiring only continued forbearance? Should there be a distinction in treatment depending on whether the contract or lease is sold to an unrelated party or is retained as part of the reorganized business, whether the business remains within the existing corporate entity or is transferred to a new legal entity? The issue has become of greater importance in the current economic system, where so much of a business's assets and relationships are tied up in contracts of varying length rather than in ad hoc, "on account" dealing. Again, another rebalancing will be required.

5.2.4. Absolute Priority vs. Relative Priority

The Bankruptcy Code distribution scheme under a chapter 11 plan currently relies on the absolute priority rule, based on a judicial valuation, as the default rule when the various classes of creditors and shareholders cannot reach an agreement on the distribution under the plan. *See* 11 U.S.C. § 1129(b)(2). The absolute priority rule requires that each class of claims or interests receive fully compensatory treatment under the plan before any junior class may share in the distribution. *See Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106 (1939). However, the Code permits deviations from absolute priority where a particular class accepts less favorable treatment than strict absolute priority would provide. 11 U.S.C. §§ 1129(a)(8), (b)(1).

Imposing the absolute priority rule requires a reorganization to operate as a recognition event, based on the business's current valuation. It cuts off the ability of out-of-the-money junior creditors and shareholders to recover if either valuation increases after the reorganization or if the valuation was incorrectly low. In addition, imposing the absolute priority rule relies on judicial valuation, which is inherently uncertain. The Supreme Court has questioned its efficacy and accuracy in requiring that a market test be used instead when current management proposes a non-consensual plan that allows existing equity holders to retain a share in the reorganized business. *Bank of Am. N.A. v. 203 N. LaSalle Ltd. Pshp.*, 526 U.S. 434 (1999). The uncertainty inherent in judicial valuation has led parties to negotiate resolutions that reflect a relative priority distribution scheme. That is, a consensual plan often leaves value for junior creditors and shareholders, often in the form of a small equity interest or warrants that will have value if the business prospers or if the valuation was too low. *See* Douglas Baird & Donald Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 YALE L.J. 1930, 1937 (2006).

These factors have led some scholars to call for a relative priority rule. Under that rule, the firm's value is distributed among all classes of creditors and shareholders, but the share that each receives is based not only on the size of the class's claim but also on its priority in the capital structure. So between senior and junior classes with equal claim amounts, for example, the senior class would receive a much larger share of the distribution, but the junior class would still be left with something, which could return value in an upside scenario. The classes could reach agreement on value distribution through negotiation, confirmed by class voting, subject to the constraints noted above to protect against non-commonality of interests within a particular class. The difficulty arises when the classes cannot reach agreement. In that situation, a judicial solution is required to prevent stalemate. In implementing relative priority, a judicial solution is preferable to a market solution, because by its nature, a market solution (such as a sale) amounts to a recognition event, cutting off any possibility to future upside.

The difficulty will be in devising standards that a court can apply in a relative priority world. Although a judicial valuation may be inaccurate in an absolute priority world, it gives a definite answer. Where the rule is relative rather than absolute, fashioning a rule that can be applied in the absence of an agreement and without an advanced degree in mathematics may pose challenges. Anthony J. Casey, *The Creditors' Bargain and Option-Preservation Priority in Chapter 11*, 78 U. CHI. L. REV. 759 (2011). Nevertheless, any rethinking of chapter 11 will require a rethinking of the absolute priority rule and the default rule when stakeholders cannot agree on distribution of value under a reorganization plan.

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Changes in German Insolvency Law to Facilitate Restructuring

by

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1. Introduction

Restructuring according to chapter 11 is a hallmark of the American legal system and is noted internationally for its pragmatic approach and its role in salvaging jobs and businesses. As the financing industry and the structure of a typical company's debt have changed markedly since its enactment in 1978, some American insolvency experts are now calling for reform of chapter 11.

Ironically, this comes at a time when other countries are just about to fully adopt many important features of chapter 11 in their own insolvency laws. One prominent example is Germany where, only very recently on 1 March 2012, the most relevant parts of the "Act to Facilitate the Restructuring of Companies" (*ESUG*) have entered into force.

ESUG will significantly change German insolvency law. Its main objectives are

1. implementation of a debt-to-equity swap or other corporate measures as part of the insolvency plan proceedings (*Insolvenzplanverfahren*);
2. procedural improvements in the insolvency plan proceedings in order to accelerate the proceedings;
3. facilitation of the self-administration (*Eigenverwaltung*) of insolvent companies by their current management instead of by an insolvency administrator;
4. "protective shield proceedings" (*Schutzschirmverfahren*) to allow the insolvent company to prepare an insolvency plan without the risk of enforcement measures being taken by creditors; and
5. improvements to creditor participation in the early stages of the insolvency proceedings, in particular with respect to the appointment of a preliminary insolvency administrator.

The act has been described by legislators as a major breakthrough for a "new insolvency culture". Although it is definitely a step in the right direction, further steps will be required to make German insolvency laws fully competitive.

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2. Debt-to-Equity Swap or other Corporate Measures as Part of the Insolvency Plan Proceedings

One important deficiency in German insolvency law was that claims of creditors could not be converted into shares of the insolvent company without the approval of the existing shareholders of the company, who had to resolve upon capital measures or sell shares in the company. Therefore, shareholders were in a position to block restructurings which would have been economically reasonable.

The new law expressly provides that arrangements concerning the shareholding (i.e. in particular a debt-to-equity swap) may be part of an insolvency plan.

2.1. New Flexibility Concerning Corporate Measures

In an insolvency plan, the current shareholders of the company can be treated like a creditors' group. However, their rights to object against the insolvency plan are reduced. An objection is only permitted if

- shareholders are treated worse than in a regular insolvency proceeding without an insolvency plan (which in practice should not play a role, as in a regular insolvency proceeding shareholders will normally not receive any distribution of the proceeds at the end since there will be no surplus after distribution to the creditors);
- a creditor receives more than the full amount of its claims against the company as a result of the insolvency plan; or
- a shareholder is treated unequally to other shareholders (i.e. an objection cannot be based on unequal treatment of shareholders compared to the company's creditors).

The insolvency plan may provide for any corporate measures permitted by German corporate law, e.g. the transfer of shares, capital measures such as an increase (against contributions in cash or in kind) or decrease in the share capital and/or the exclusion of subscription rights. If the insolvency plan contains such provisions, no further formalities (e.g. shareholder approvals, notarizations etc.) need to be observed. These possibilities allow new innovative restructuring measures as part of an insolvency plan proceeding – and this includes measures going beyond a debt-to-equity swap.

If a debt-to-equity swap is implemented by way of a capital increase (i.e. debt is contributed as contribution in kind) the company cannot assert any claims against the subscribing creditor based on an alleged over-valuation of the contributed debt after the insolvency plan has become effective. However, the number of shares to be issued to the creditors under the insolvency plan needs to be determined based on the fair market value of the creditors' claims. The insolvency court is entitled to review the fair valuation of the claims when confirming the insolvency plan.

2.2. Change-of-Control Protection

In addition, the new law protects the company against adverse effects which may result from a change of control following the debt-to-equity swap:

- A shareholder who has the right to exit the company as a consequence of the aforementioned corporate measures (e.g. because the articles of association provide that a shareholder is entitled to terminate its membership in the event of a change of control) would generally be entitled to receive compensation according to the fair market value of the shares. The new law provides that this compensation will be calculated based on the liquidation value of the company, not on the basis of its going-concern value.
- Contractual partners of the company are not entitled to terminate their contractual relationship with the company because of the aforementioned corporate measures. Contractual provisions providing otherwise are void.

2.3. Consent of Creditors Required

We expect that the new rules concerning debt-to-equity swaps may significantly extend the chances for a restructuring by way of a debt-to-equity swap. However, for the implementation of the debt-to-equity swap the consent of each individual creditor is still required. Only under the German Bond Restructuring Act (*Schuldverschreibungsgesetz*) a majority of 75% of the bondholders can force the other bondholders to participate in a debt-to-equity swap. A bond restructuring is also possible as part of an insolvency plan proceeding.

3. Procedural Improvements in the Insolvency Plan Proceeding

The new law provides for procedural improvements in the insolvency plan proceedings (*Insolvenzplanverfahren*). Major improvements are:

3.1. Limitation of Consequences of Creditors' Complaints

The possibility of creditors to block an insolvency plan will be reduced by a new fast-track proceeding. The court may upon request of the insolvency administrator immediately reject the complaint of a creditor if the disadvantages of a delayed implementation of the insolvency plan outweigh the individual disadvantages which the creditor suffers from the implementation of the insolvency plan and if no severe violations of law occurred in the setting-up of the insolvency plan. As compensation for the rejection of the complaint, the creditor may – in a separate court proceeding – claim compensation for the damages suffered by the implementation of the insolvency plan from the insolvency estate.

Additionally, a creditors' complaint is to be rejected if the insolvency plan provides for compensation of creditors treated worse than in a regular insolvency proceeding; the question whether the specific creditor is entitled to receive funds according to this provision of the insolvency plan is to be dealt with in a separate court proceeding.

3.2. Limitation of Delayed Claims

Under the old law, there was no specific time limit to assert claims after the insolvency plan became effective, i.e. only the general statutes of limitation applied. As a consequence, creditors who did not register their claims could ask for payment of the dividend set forth in the insolvency plan. Despite the limitation of claims to the dividend, creditors with substantial unregistered claims could jeopardize the payment on claims as set forth in the insolvency plan.

The new law reduces, but does not fully eliminate this issue: any claims which have not been registered with the insolvency administrator prior to the creditors' assembly resolving upon the insolvency plan become time-barred one year after the insolvency plan has become final and binding and the respective claim has become due. Additionally, the court may prohibit enforcement measures of creditors who have not registered their claims with the insolvency administrator prior to the creditors' assembly resolving upon the insolvency plan for up to three years if such enforcement measures put the implementation of the insolvency plan at risk.

3.3. Duration of Insolvency Plan Proceedings Still Problematic

The creditors' rights to challenge an insolvency plan have been reduced and further procedural improvements have been implemented. However, in general, an insolvency plan proceeding will probably still require at least five months. This is a particular problem if the customers do not continue their business with a company in pending insolvency proceedings (e.g. because they have to rely on long-term warranty claims).

4. Facilitation of Self-administration

The new law further seeks to improve the use of self-administration (*Eigenverwaltung*), which is supposed to correspond to the debtor-in-possession concepts known in other countries. In this case, the company will be run by its current management and the insolvency court only appoints a supervisor (*Sachwalter*) who observes the conduct of business by the management.

Also, the old insolvency law offered the insolvency court the option to allow self-administration by the company. However, the courts were not obliged to do so and in practice only rarely did.

4.1. Self-administration of the Company as a Rule

The new law introduces self-administration as a rule, i.e. an application for self-administration may only be rejected if circumstances exist due to which creditors may suffer disadvantages from the self-administration (e.g. a lack of skills of the management). Prior to making a decision about the self-administration, the insolvency court must hear the preliminary creditors' committee unless this hearing would obviously affect the financial situation of the company negatively.

Additionally, the insolvency court must refrain from restricting the authority of the management to dispose of assets of the company and from imposing a requirement of consent by a preliminary insolvency administrator unless the application of the company for self-administration is obviously unfounded. Control over the management will only be exercised by the supervisor.

4.2. Chance to Withdraw the Filing for Insolvency

If the company has filed for insolvency only because of imminent illiquidity (rather than actual illiquidity or over-indebtedness) and the court intends to reject the application for self-administration, the court shall inform the company accordingly and give the company a chance to withdraw the filing for insolvency. In case of a withdrawal, the company would only be obliged to file for insolvency again if it actually becomes illiquid or over-indebted later on.

As the new law will facilitate self-administration and introduce it as a rule, we expect to see more self-administration proceedings in the future. This is a positive development, as self-administration should enhance the chances of a restructuring in an insolvency plan proceeding.

5. Protective Shield Proceeding Against Enforcement

The ESUG further implements a new protective shield proceeding (*Schutzschirmverfahren*) which allows companies that are not actually illiquid to prepare an insolvency plan without the risk of enforcement measures initiated by individual creditors.

5.1. No Enforcements for Three Months

In this case, the insolvency court may set a time period of up to three months in which the company can prepare an insolvency plan. The court may further provide that enforcement measures of creditors are prohibited for this time period. Together with the application, the company has to provide a certificate by a tax advisor, auditor, lawyer or comparable person which states that the company is only in a state of imminent illiquidity or over-indebtedness (not actual illiquidity) and that the intended restructuring is not obviously impossible.

5.2. Preparation of Insolvency Plan under the Supervision of a Supervisor

The protective shield proceeding is an interesting tool which allows an insolvent company to prepare an insolvency plan under the supervision of a supervisor appointed by the court but selected by the company. In our view, protective shield proceedings will therefore be a valid option for companies in crisis to restructure the business as part of an insolvency plan proceeding.

However, there are some unresolved legal questions relating to protective shield proceedings which have not yet been addressed by legislators and for which legal practice will have to find viable solutions. Also, it appears to be uncertain whether the new instrument will have much effect with respect to companies that have already reached the state of over-indebtedness. In practice, such companies are often also actually illiquid so that the protective shield proceeding cannot be applied. At the least – and contrary to the original government proposal – the protective shield proceeding can be continued if the company becomes actually illiquid within the period set by the insolvency court for the preparation of the insolvency plan.

6. Improvement of Creditors' Participation in Insolvency Proceedings

Last but not least, the new law improves the participation of creditors in the early stages of the insolvency proceedings. Under the old law, immediately after the company's filing for insolvency the insolvency court appointed a preliminary insolvency administrator (*vorläufiger Insolvenzverwalter*) who was supposed to secure the assets of the insolvent company and to prepare the opening of the final insolvency proceedings. The creditors of the company were not involved in the selection of the preliminary insolvency administrator or any other measures taken prior to the opening of the final insolvency proceedings, which generally took place approximately three months after the filing for insolvency. In practice, the key decisions regarding the continuation of the company's business and the restructuring measures were, therefore, already taken before the creditors were involved in the process for the first time. The ESUG now provides for creditor participation in the early stages of the company's insolvency.

6.1. Preliminary Creditors' Committee

Together with its filing for insolvency, the insolvent company has to submit a list of creditors to the insolvency court. The list has to highlight the highest claims, the highest secured claims, the claims of tax authorities, the claims of social security agencies and the claims arising from company pension schemes. When submitting the list of creditors, the company has to declare that the data provided therein is complete and correct.

Based on the information provided by the company, the insolvency court is obliged to appoint a preliminary creditors' committee (*vorläufiger Gläubigerausschuss*) if the company has reached two of the following thresholds in the previous fiscal year:

– total balance sheet value of at least EUR 4,840,000;

– revenues of at least EUR 9,680,000;

– at least 50 employees as an annual average.

Even if the insolvent company does not reach the aforementioned thresholds, the insolvency court may appoint a preliminary creditors' committee. Upon request of (i) the company, (ii) the preliminary insolvency administrator or (iii) a creditor, the insolvency court shall appoint a preliminary creditors' committee if the request contains a proposal for members of the creditors' committee and declarations of the respective persons that they are prepared to act as members of the preliminary creditors' committee.

However, a preliminary creditors' committee is not to be established if (i) the company has ceased its business activities, (ii) the implementation of a preliminary creditors' committee appears to be inappropriate given the expected insolvency estate, or (iii) the delay caused by the implementation of the preliminary creditors' committee would negatively affect the financial situation of the company. The last exemption in particular could be of relevance in practice because time is of the essence after the company has filed for insolvency in order to stabilize its business operations.

6.2. Influence on Composition of Preliminary Creditors' Committee

In order to facilitate the appointment of the preliminary creditors' committee and the preliminary insolvency administrator, the company should (i) prepare the list of creditors to be submitted well in advance of the filing for insolvency and (ii) discuss with its major creditors which persons could and would be willing to serve as members of the preliminary creditors' committee. Ideally, the company would further co-ordinate with the potential members of the preliminary creditors` committee regarding the person to be appointed as a preliminary insolvency administrator.

6.3. Influence on Selection of Preliminary Insolvency Administrator

If a preliminary creditors' committee is established, then prior to the appointment of a preliminary insolvency administrator the insolvency court must hear the preliminary creditors' committee with respect to general qualifications of the preliminary insolvency administrator and proposals regarding the person to be appointed as preliminary insolvency administrator. This obligation does not exist if the hearing of the preliminary creditors' committee would obviously affect the financial situation of the company negatively.

If the preliminary creditors' committee has unanimously adopted a proposal as to which person is to be appointed as preliminary insolvency administrator, the insolvency court is bound as a matter of principle to this proposal and may only refuse to appoint the respective person if the proposed person is – based on the general qualifications requested by the preliminary creditors' committee – unsuited to become the preliminary insolvency administrator.

If the insolvency court has not heard the preliminary creditors' committee prior to the appointment of the preliminary insolvency administrator, the preliminary creditors' committee can in its first meeting unanimously nominate a different person to be appointed as the preliminary insolvency administrator.

The same competences of the preliminary creditors' committee apply with respect to the appointment of the final insolvency administrator.

6.4. Practical Uncertainties Remain

It remains to be seen to what extent the insolvency courts will already involve preliminary creditors' committees before the actual appointment of the preliminary insolvency administrator. Since time is of the essence after a company has filed for insolvency, it may turn out that the insolvency court appoints the preliminary insolvency administrator without hearing the preliminary creditors' committee, so that the preliminary creditors' committee would have to dismiss the preliminary insolvency administrator in its first meeting.

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PARIS, 22 JUNE 2012

"Re-thinking Chapter 11:

Some thoughts from an English perspective."

By

Michael Crystal QC

1. There is no self-administration model in England

England does not have a self-administration model in the sense described by Professor Klee and Mr. Levin in their paper. England has as its principal corporate rescue tool a statutory administration procedure. Brief details of the history and some aspects of this procedure are mentioned below.

Background to legislative change

In the mid to late 1970's a number of countries in the Anglo-Saxon legal family were actively considering insolvency law reform[1]. In 1977 the British government appointed a committee to review insolvency law and practice in England and Wales and make recommendations for reform. The chairman of the committee was Sir Kenneth Cork[2]. The Cork committee reported in 1982. Its report is colloquially known as "the Cork Report"[3]. The Cork Report contained the first comprehensive review of the law of insolvency in England and Wales in more than a century.

The need for a rescue regime in England

The Cork committee was satisfied that in a significant number of cases companies had been forced into bankruptcy[4] and potentially viable businesses capable of being rescued

[1] These included the United States, Canada, Australia and New Zealand.

[2] Sir Kenneth Cork was an accountant and City figure. He was the most well-known insolvency practitioner of his day. The majority of his committee were judges and lawyers.

[3] "Insolvency Law and Practice: Report of the Review Committee June 1982". Cmmd 8558.

[4] Known in England as 'liquidation' or 'winding-up'. A convenient brief description of this procedure can be found in *Re T & N Ltd* [2005] 2BCLC 488, 512, per Mr. Justice David Richards.

had been closed down for want of a suitable mechanism which could be used in all cases[5].

The Cork Report proposed that there should be introduced a new procedure involving the appointment of an 'administrator' under which the Court could appoint a suitably qualified third-party as a fiduciary to consider the reorganisation of a company and its management with a view to restoring profitability or maintaining employment, to ascertain whether a company of doubtful solvency could be restored to profitability and/or to make proposals for the most profitable realisation of assets for the benefit of creditors and shareholders.

This proposal was, in substance, accepted by the Government and in 1986 the administration procedure came into force. The principal provisions concerning administration are contained in the Insolvency Act 1986, and the Insolvency Rules 1986, both as amended by subsequent primary and secondary legislation. With some important subsequent legislative changes the administration procedure has been in existence for nearly 25 years.

The Cork Report contained no international comparison of the pros and cons of any foreign restructuring or rehabilitation regime. There was no specific discussion of Chapter 11. The Report simply referred, in passing, to new insolvency codes then recently introduced or proposed in the United States, France and the Federal Republic of Germany.

The fundamentals of administration

Under the administration procedure the administrators are officers of the Court and therefore fiduciaries. They have the express right to seek the directions of the Court. Their statutory duty is to take control and manage the business and assets of the company. They have wide powers to realise assets. The exercise of those powers, and other powers associated with the management of the company's business, are regarded by the Court as matters for the commercial judgment of the administrators rather than as appropriate matters for directions by the Court[6].

Between 1986 and 15 September 2003 an administrator could only be appointed by the Court. Since then, he can be appointed either by the Court or out of Court[7].

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[5] Previously this had only been possible where a creditor holding security including 'a floating charge' had been given power to appoint a receiver and manager of the whole property and undertaking of the company.

[6] *Re T & N Ltd* [2005] 2BCLC 488, 512- 513 discussing the legislation in force pre September 2003.

[7] Including appointment by the company or its directors.

Notwithstanding appointment out of Court, the administrator remains a fiduciary who has an express right to seek the directions of the Court.

Some brief contrasts with Chapter 11

Although UK politicians and the media have at times described the administration procedure as the UK's Chapter 11, it is different in many of its fundamentals[8]. Two of these are mentioned below.

Administration is essentially an out of Court proceeding

Although the Court can give directions or determine points arising during the course of the Administration, the English legislation essentially provides for an out of Court proceeding under the control of a licenced insolvency practitioner, usually an accountant, as a fiduciary. The process is not lawyer-driven. In many administrations, the Court has no substantial involvement at all.

There is no debtor in possession concept

The administration procedure does not recognise the concept of a debtor in possession as a fiduciary. One of the essential features of administration is the almost invariable director/management displacement on appointment of the administrator. The integrity and transparency of the administration procedure is designed by the legislation, in large part, to be ensured through third-party professional control of the company and the replacement of existing management.

2. The pre-eminence of a security holder outside the administration procedure

The English Courts[9] have laid down a series of rules designed to regulate the position as between as security holder and the company which has conferred the security ('the mortgagor'). The current position is summarised below:

(1) If the security confers a power of sale, that entitles the security holder to sell the secured property out of court as an alternative to sale by judicial process.

(2) The power of sale may be exercised by the security holder or by a receiver appointed as agent of the mortgagor.

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[8] In the first case in the Court of Appeal on the administration procedure, (*Bristol Airport plc v Powdrill* [1990] Ch 744), counsel for the administrators (this author) invited the Court to gain assistance from considering Chapter 11. Whilst emphasising the importance of the administration procedure as a rescue regime, the Court of Appeal declined to do so. A limited comparison between administration and Chapter 11 was undertaken in *Felixstowe Dock Co v US Lines* [1989] QB 360. That case has given rise to controversy, see e.g. *"Judicial Attitudes to Insolvency Law"* Crystal (1998) Company Lawyer vol. 19, 49 at 53.

[9] substantially by reference to common law principles of mortgage law

(3) The power of sale is given to the security holder for his own benefit to enable him to better realise his debt[10]. Accordingly:

(a) A security holder is at all times free to consult his own interests alone whether and when to exercise his power of sale[11]:

(b) A security holder has no duty at any time to exercise his powers to sell, to take possession or to appoint a receiver and preserve the security or its value or to realise his security[12]. In particular:

(i) He is not bound to postpone sale in the hope of obtaining a better price[13].

(ii) He is entitled to sell at the worst possible moment[14].

(iii) He is entitled to sell the secured property as it is. He has no obligation to improve it or increase its value or engage in other pre-marketing steps[15].

(4) However, a security holder is not entitled to unfairly prejudice the mortgagor[16]:

(a) The security holder, on exercising the power of sale, must take proper care, whether by fairly and properly exposing the property to the market or otherwise, to obtain the best price reasonably obtainable at the date of sale[17]. This duty prohibits a hasty sale at a knock-down price to pay off the security holder's debt[18].

(b) The security holder, having decided to sell, is required to accept or, at least, follow up an obviously favourable proposal, whether from a third party or the mortgagor[19].

Accordingly, save where the conferment or creation of the security is susceptible to challenge[20], English law has left a security holder with a relatively free hand[21] to deal with his security as he chooses outside the administration procedure.

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[10] *Palk v Mortgage Services Funding plc* [1993] Ch 330, 337.
[11] *Silven Properties Ltd v RBS plc* [2004] 1 WLR 997, CA, [14], 1004b-c.
[12] Ibid [13], 1003h.
[13] Ibid [14], 1004d.
[14] Ibid, [15], 1004f-g.
[15] Ibid, [16] and [17], 1004g-h and 1006a-d.
[16] *Downsview Nominees Ltd v First City Corp Ltd* [1993] AC 295, PC, 315.
[17] *Silven Properties* Ibid, [19], 1005f-h.
[18] *Palk* Ibid, 337-338.
[19] *Lloyds Bank plc v Cassidy* [2003] BPIR 423, CA, 440g-h.

3. Moratorium on a secured creditor dealing with security during the administration procedure.

However, under the current law, a secured creditor is prevented from taking any steps to enforce any security over the property of a company in administration except with the permission of the administrator or of the Court, subject, where the Court gives permission, to such conditions or requirements as the Court may impose[22].

The concept of security is widely defined in the legislation[23] and the Court of Appeal[24] has set out general guidance for cases where the secured creditor seeks permission to exercise existing security rights against a company in administration[25].

The result, in practice, is that the existence of the moratorium in many cases leads to a negotiated solution between the security holder and the administrator in the interests of the relevant constituencies in the administration. Where this does not happen, the Court will decide the matter.

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[20] E.g. under claw-back or non-registration legislation. A discussion of these topics is outside the scope of this paper.

[21] Absent fraud or bad faith.

[22] Schedule B1, para 43(7) Insolvency Act 1986.

[23] Ibid Schedule B1, para 43(2): *Bristol Airport v Powdrill* [1990] Ch. 744, 760D.

[24] *Re. Atlantic Computer Systems* [1992] Ch. 505 at 543h-544a.

[25] These are conveniently summarised in 'Corporate Administrations and Rescue Procedures' (2nd ed. 2004) Fletcher, Higham and Trower (eds.) para 2.26, pp 68-69.

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Chapter 11 and French Insolvency Law

Contents

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1. French Safeguard procedures: a Chapter 11 «*à la française*»

- Two major restructuring instruments for the companies subject to French Law have been introduced by reforms in 2005 and 2010: the Safeguard Procedure (*Procédure de Sauvegarde*) and the Accelerated Financial Safeguard Procedure (*Sauvegarde Financière Accélérée «SFA»*) (Law dated 26 July 2005 – modified by order dated 18 December 2008and Law dated 22 October 2010):
  - Inspired from Chapter 11 and the US prepackaged plan practice: Chapter 11 «*à la Française*».
  - Before, such reforms restructuring instruments were either (i) amicable procedures (*mandat ad-hoc / conciliation*) which require the unanimous consent of the creditors to restructure company debts or (ii) the judicial procedure (*redressement judiciaire*) in which the judge can impose to the creditors a repayment schedule up to a maximum of 10 years (which is often not sufficient) and in which the creditors' individual consent is necessary to impose the many restructuring measure other than the repayment scheduled over 10 years.
- Aims of these new procedures:
  - To encourage companies to seek court protection before the suspension of payments (*cessation des paiements*) and prevent bankruptcy, and
  - To facilitate the adoption of a safeguard plan by submitting such plan to the creditors committees' majority votes.
- Even if French insolvency reforms have been influenced by the main principles governing the US Chapter 11, the rationale of French and US Law is quite different:
  - In the French safeguard procedure the social interest and the maintaining of employments contracts prevail on the other interests and in particular on the creditors' ones. In US, insolvency Law aims at maintaining continued business and at granting to the creditors a satisfactory repayment – cf. *Best Interest Test*. In France, on the contrary, solutions in favour of the employees are adopted even though they are unfavourable to the creditors' interests.

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2. Central role of the debtor

To ensure a continued business and incentivize the management to initiate a safeguard procedure:

- The procedureis a voluntary procedure *i.e.*, it is opened only at the request of the debtor.
- When the procedureis open the manager remains in charge of the management of the company (inspired from the principle of *debtor in possession*). Nonetheless, the manager is either supervised or assisted by a receiver court appointed.
- The debtor is in charge of drawing up the safeguard plan under the supervision of the receiver. Safeguard rules do not provide for any possible take over of the business by a third party: the debtor keeps the control over his business.

3. Facilitating of the opening of the procedure

- The opening of a safeguard procedure requires that:
  - The company must not be in a «state of suspension of payment» (*état de cessation des paiements*): *i.e.*, the impossibility to face the accrued liabilities with the company's available assets. It is specified that the debtor must not be in a state of suspension of payment during the procedure.
  - The company faces «*difficulties that the debtor cannot overcome on its own*».

  Recent evolution in case law: some court decisions have tried to restrict this criteria to avoid abusive recourse to the safeguard procedure but the French Supreme Court, (8 March 2011, Cœur Défense) has adopted a broad definition of this concept of «difficulties», and in particular the difficulties which allow the opening of a safeguard procedure do not necessarily need to be difficulties which affect the debtor's activity.

  Initially French Law required «*difficulties likely to lead to a state of suspension of payments». Since 2008, any reference to the suspension of payments to define the nature of the difficulties has been removed to allow a more extensive definition of the such «difficulties».*

- The opening of a safeguard procedure starts an observation period of a maximum of 18 months. During this period:
  - The receivables arosin prior to the opening of the procedure are frozen,
  - The proceedings initiated before the opening are interrupted,
  - Any enforcement proceeding is prohibited, and
  - The creditors have to file their claims.

- Question raised: whether a safeguard procedure could be opened to the benefit of companies which do not have any employee, any industrial or commercial activity, such as holding companies or SPV created for financial purposes:
  - Case law Cœur Défense: the court has accepted the opening of a safeguard procedure for SPV.

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4. Creditors' committees

- For companies with over 150 employees **<u>or</u>** a turnover exceeding 20 M€, creditors committees shall be appointed within 30 days from the opening of the procedure.
- The 2 committees to be appointed are:

(i) the main suppliers' committee,

(ii) the financial creditors' and assimilated creditors' committee.

In addition the bondholders, if any, have to be consulted all together within the context of a general meeting, pursuant to the same rules as the ones applicable to the committees (cf. following slide).

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5. Vote of the creditors' committees (1/2)

- The management is authorized to submit different plans to the different committees but also to treat differently the creditors of a same committee if their situation explains such difference of treatment.
- The plan may consist of any appropriate solution submitted by the debtor and in particular of waiver of debts, debt to equity conversion for the companies in which the liability is limited, installments of the repayments, etc.
- The plan has to take into account the subordination agreements entered into before the opening of the procedure.
- The committees have to adopt the proposed plan at the majority of 2/3 of the claims held by the voting creditors:
  - ↪ The majority initially required was a double majority: (i) majority of the voting creditors (ii) holding 2/3 of the claims held by the creditors of the committee.
  - ↪ The majority has now been simplified to facilitate the adoption of the safeguard plan.
  - ↪ Even if the procedure is a judicial procedure a negotiation is necessary to reach the required majority in each committee.
- It has been noticed that safeguard procedures have been opened without appointing any committee (as French Law does not provide for any consequence for the lack of appointment) in order to impose to the creditors a repayment schedule over 10 years:
  - ↪ Cf. Case law Cœur Defense.
  - ↪ Risk of misappropriation of the use of the safeguard procedure.

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5. Vote of the creditors' committees (2/2)

- If a committee does not approve the plan, the later cannot be adopted by the court. Thus the solution is the one which was applicable prior to the creation of the safeguard procedure i.e.:
  - The court can only impose to the creditors an installment of their repayments over 10 years.
  - If any other solutions are requested by the plan, such as a conversion of the debt into equity or a waiver of the debts, thus these solutions could be implemented only for those of the creditors who have individually accepted them.

- The court is entitled to refuse to approve the plan in the case where the interests of the creditors are not sufficiently protected. In such case the situation is the same as the one mentioned above.

6. Accelerated Financial Safeguard Procedure (*Sauvegarde financière accélérée «SFA»)*

- SFA has been created as a result of:
  - ➥ The fact that many conciliation procedures have failled due to the necessary unanimous consent of the creditors: a minority of the creditors could cause the failure of adoption of the plan.
  - ➥ The acknowledgement of the fact that safeguard procedures have been used to overcome negotiation difficulties with creditors. French practice of the «*prepack*»: Autodis (2009) / Technicolor (2010) where Courts have adopted plans negotiated within the context of a conciliation procedure.
- SFA only concerns the restructuring of financial debts – only financial creditors are impacted by the plan while the other creditors are excluded.
- SFA is a simplified and accelerated safeguard procedure which shall last a maximum period of one month (renewable once) used in order to force the minority of financial creditors to adopt a plan.
- Opening conditions are in particular:
  - ➥ Difficulties the debtor cannot overcome,
  - ➥ Not being in a state of suspension of payments,
  - ➥ Ongoing conciliation procedure,
  - ➥ A company having over 150 employees, or a turnover exceeding 20M€ or, a total balance sheet exceeding an amount to be still determined by a decree: recent Law dated 22 March 2012 added this last possibility to open a SFA procedure to allow holding companies in LBO transactions to open a SFA,
  - ➥ The debtor should have prepared a plan aiming at ensuring the continuity of the business and that shall likely be approved by the majority of the creditors.

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