BANKRUPTCY CODE SUMMARY Chapter 11 entails a renegotiation among creditors, managers and stockholders.

VALUATION

Who wins and who loses in Chapter 11? The initial answer will turn on how much the firm is worth. The more value there is in the firm, the further down the capital structure pecking order the court can move.

New York, New Haven and Hartford RR Company:

Summary: Valuation fight between mortgage bondholders (pushing for a low valuation based on observed market prices) and income bondholders (pushing for a higher valuation based on 'intrinsic value' rather than market price).

Finding: ***Use of a substitute "reorganization value" (instead of the market value of the firm's assets) may under the circumstances be the only fair means of determining the value of the securities distributed***, given that the market is unsettled because of social, political and economic stresses current on the domestic and international scenes. It is reasonable to assume that much more time is necessary for the marketplace to absorb, digest and react rationally to the available information concerning the Asset Disposition Program, the Valuation Case and the complext capital structure … It is evident that traditional valuation methods employed by investors cannot be readily applied to the securities in question.

To be confirmed, a plan of reorganization must be feasible and it must be fair, even if the required percentage of classes has approved it

NewCo must have a sound capital structure
The NewCo must be sustainable as a going concern
There must not be alternative course of action which are not subject to objections of fairness or of feasibility
Liquidation may be necessary if it develops that not reorg can be effected on a fair and reasonable basis

There are four key methods to control priority worthy of attention

1) Contractual subordination
2) Security
3) Negative pledge clause
4) Holding company structure

Related concepts in terms of determining priorities include

1) Equitable subordination
2) Substantive consolidation of holding companies
3) Treatment of illegal securities issues in bankruptcy
4) Treatment of interest during the firm's reorganization

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EVOLUTION OF A CHAPTER 11 PROCEEDING AND KEY ISSUES
Automatic stay (S 362) enjoins all attempts to collect from the debtor

Occasionally, but rarely, creditors seek to oust management and appoint a trustee under S. 1104 ("for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the … debtor by current management … or if such appointment is in the interests of creditors")

The new post-petition lender usually gets a super-priority above pre-bankruptcy lenders

Secured creditors often ask the court to lift the stay, so that they can foreclose

The statute requires that the debtor and court provide the secured creditors with adequate protection of their security interests, which usually is done via periodic cash payments to compensate the secured creditor for the deteriorating value of its collateral. Sometimes the secured property produces cash, which could be subject to a creditor's lien. The debtor would like to use this cash and usually asks the court to find some other adequate protection for the secured creditor so that the debtor can use the cash to revive himself

Los Angeles Lumber
"Where a plan is not fair and equitable as a matter of law it cannot be approved by the court even though the percentage of the various classes of security holders required by the Bankruptcy Act for confirmation of the plan has been consented … Congress has required both that the required percentages of each class of security holders approve the plan and that the plan be found to be 'fair and equitable'".

" … to the extent of their debts creditors are entitled to a priority over stockholders against all the property of an insolvent corporation."

"It is, of course, clear that there are circumstances under which stockholders may participate in a plan of reorganization of an insolvent debtor. Where … the old stockholders make a fresh contribution and receive in return a participation reasonably equivalent to their contribution, no objection can be made …"

"To accord 'the creditor his full right of priority against the corporate assets' where the debtor is insolvent, the stockholders' participation must be based on a contribution in money or in money's worth, reasonably equivalent [in value to the stock received]."

"To hold that in a reorganization creditors of a hopelessly insolvent debtor may be forced to share the already insufficient assets with stockholders because apart from rehabilitation under that section they would suffer a worse fate [in liquidation], would disregard the standards of 'fair and equiable'; and would result in impairment of the Act to the extent that it restored some of the conditions which the Congress sought to ameliorate by that remedial legislation."

BANKRUPTCY CODE SUMMARY Chapter 11 entails a renegotiation among creditors, managers and stockholders.

ABSOLUTE PRIORITY

Several elements of the absolute priority rule are inter-connected

1) Creditors have "absolute priority" over stockholders, i.e. they are to be paid in full before stockholders receive anything
2) Creditor consent to deviation from that priority via a creditor vote is not dispositive
3) When there are intermediate creditors, creditors cannot skip over an intermediate class to consent to a lower class' participation

The absolute priority rule evolved in order to ensure that "the great power exercised outside the proceedings by the inside few will be exercised within the proceedings for the benefit of the investor."

SEC Report on Protective Committees as to corporate reorganizations
Target: ability of a few insiders, whether representatives of management or major creditors, to use the reorganization process to gain an unfair advantage

Report rejected the use of the "composition result" (best interests) test which "was always to give old shareholders [stock valued at the] difference between liquidation and full going concern value of the assets." ... It was believed that creditors, because of management's position of dominance, were not able to bargain effectively without a clear standard of fairness and judicial control.

The heart of the application of the absolute priority rule is the valuation of the business. The participation of junior creditors and equity security holders depends upon the finding of a value in the business over and above that of the claims of the senior interests

In the 1938 Bankruptcy Act, there was Chapter X and Chapter XI. Chapter X was for public companies. Chapter XI was originally for smaller, closely-held companies and had standards for reorganization different from those in Chapter X. A majority of the creditors could force dissenting creditors to accept a plan, even if the plan violated absolute priority, although it could not violate absolute priority so much that the dissenting creditors would receive less than their liquidation value.

Key features of contemporary absolute priority

Plan approval (though not necessary for confirmation): all impaired classes vote in favor of the plan
If an impaired class votes against the plan, it may still be confirmed via a *cramdown*:
- Plan does not discriminate unfairly
- Plan is fair and equitable --> impaired classes receive the allowed amount of claim or nothing for junior holders and interests

Acceptance of a plan by a particular class if it is voted for by 2/3 in value and 1/2 in number of each such class of creditors

If unimpaired --> deemed to accept
If zero value --> deemed to reject

BANKRUPTCY CODE SUMMARY Chapter 11 entails a renegotiation among creditors, managers and stockholders.

ABSOLUTE PRIORITY

According to S 1129 (b)'s cramdown conditions, in order for a plan with cramdown to be confirmed by the court, the plan must be fair and equitable and must not discriminate unfairly

Fair and equitable: absolute priority standard
Not discriminate unfairly: pro rata, equal tratment, after giving effect to side-deals, within a class

BEST INTERESTS TEST

S. 1129 (a)(7) on requirements for confirmation include that with respect to each impaired class of claims or interests, each holder of a claim or interest of such class has accepted the plan or will receive or retain under tha plan on account of such claim or interest property of a value, as of the effective date of the plan, that is not less than the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date.

SECURED CREDIT

An allowed claim of a creditor secured by a lien on property in which the estate has an interest … is a secured claim to the extent of the value of such creditor's interest in the estate's interest in such property, or to the extent of the amount subject to setoff, as the case may be, and is an unsecured claim to the extent that the value of such creditor's interest or the amount so subject to setoff is less than the amount of such allowed claim. Such value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest.

PRIORITY OF PAYMENT AHEAD OF GENERAL UNSECURED CREDITORS

S 507(a) gives priority above that of general unsecured creditors to several claimants:

1) Administrative expenses, including post-petition trade credit and secured adequate protection expenses
2) Gap creditors who are trade creditors whose claim arose after the filing of the petition but before the order of relief
3) Back wages to the debtor's employees, limited in amount and time
4) Monies due to employee benefit plans, again limited in amount and time
5) Special provision for grain facilities
6) Return of deposits to those who paid the debtor for goods or services that weren't delivered, but limited in amount
7) Some taxes

ELIMINATION OF SHAREHOLDERS' INTEREST

In order for shareholders to have their interest eliminated, the bankruptcy court must go through a complicated fact-finding trial (under S 1129(b)(2)) to determine whether the company is insolvent. The court must take extensive testimony on the actual value of the company's assets, listen to experts from opposing sides, and come to some supportable conclusion itself … confirmation of a of reorganizatino for a company operating under Chapter 11 is delayed.

It is not in the unsecured creditors' best interest … to engage in a length battle, especially if the outcome is uncertain … The unsecured creditors' experts will testify that the corporation is insolvent and that the shareholders' interests should be eliminated. The shareholders' experts will testify that the corporation is clearly solvent and the shareholders should retain their stock ownership, or have it diluted minimally. Creditors, though, wil be willing to negotiate only if there are some shareholders with whom they can negotiate. Shareholders must … form a committee to negotiate to protect their interests."

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ELIMINATION OF SHAREHOLDERS' INTEREST

When the court appointed an equity holders' committee, equity was nearly certain to get something, averaging about 7% or 8%, in the S. 1129(a)(8) settlement.

POST-PETITION INTEREST

Section 502(b) thus contains two principles of present law. First, interest stops accruing at the date of the filing of the petition, because any claim for unmatured interest is disallowed under this paragraph. Second, bankruptcy operates as the acceleration of the principal amount of all claims against the debtor.

ASSET SALES UNDER SECTION 363

Section 363 authorizes the trustee to sell the bankrupt's property.

Section 363(c) says that the trustee or the debtor-in-possession "may enter into transactions, including the sale or lease of property of the estate, in the ordinary course of business, without notice or a hearing …" A sale of the entire company is not a sale in the ordinary course of business, so S 363(c) is unavailable. But S 363(b)(1) says: "The trustee, after notice and hearing, may use, sell or lease, other than in the ordinary course of business, property of the estate."

It's the trustee (or the debtor-in-possession) that must move the court to make the sale. Creditors cannot move under S 363 themselves.

If creditors dislike the debtor-in-possession's decision to forego a S 363 sale, they can move that the court replace the management of the DIP with a trustee friendly to the creditors and amenable to a sale. But although the judge can appoint a trustee to displace the bankrupt's managers, trustee appointment is rare. Under S 1104, the standard for trustee appointment is "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the … debtor by current management … or if such appointment is in the interests of the creditors." Or, the creditors could negotiate a plan of reorganization under S 1129(a)(8), with the plan contemplating a sale. But, since the creditors presumably want a sale in order to avoid negotiating, cramming down nd valuing under S 1129, the last alternative isn't much of a benefit.

Braniff Airways

"The debtor and the Bankruptcy Court should not be able to short circuit the requirements of Chapter 11 for confirmation of a reorganization plan by establishing the terms of the plan sub rosa in connection with the sale of assets."

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BUYING UP CLAIMS

In order to ram through a POR favorable to itself, a creditor cannot just tender for 2/3 of each class of debt, with its obligation to close and actually buy up the debt contingent on each class of creditors and interests approving a plan of reorganization that contemplates a third party sale. Under S 1126(c)-(e), class acceptance does not include acceptance by "any entity whose acceptance or rejection of such plan was not in good faith, or was not solicited ... in good faith."

> 1126(e): "On request of a party in interest ... the court may designate any entity whose acceptance or rejection of such plan was not in good faith."
>
> The possible problem being addressed here is as follows. The buyer of the claims may be interested in its total take in the reorganization, prepared to take less on one level than he gets on another.

REORGANIZATION VALUE

On the judiciary and valuation:

> ***Equity Funding Corp of America***
>
> "... In effect, this approach frees reorganizations from prices which are pegged by forced sales or by the temporary conditions of the market place. Instead, reorganization value is intended to approach the value that would prevail in a perfect market adequately stocked with willing and informed buyers and sellers."
>
> "Reorganization value represents the best estimate of value the marketplace would put on a company comparable to New Company. However, because of uncertainties associated with a company emerging from Chapter X proceedings, possible initial selling pressure, and perhaps other factors, individual shares of stock of New Company may trade in the near future at less than reorganization value."

Reorganization value is the substitute for market value in reorganization ... Basically it purports to determine what classes of claimants are entitled to be satisfied in whole or part out of the assets of the distressed company.

Market value is a real value in that it not only is expressible in dollar terms but is realizable in dollars ... In marked contrast, reorganization value has the opposite characteristics. It is a fictional value which cannot command real money dollar for dollar. It is set by the estimates of persons who are not standing back of them with a willingness to invest their own funds. Accordingly, it can never be objectively ascertained or verified but always remains in the realm of opinion or belief.

Securities of the reorganized company will be independently priced by the market regardless of how they were valued for purposes of the reorganization. In the period immediately following reorganization [under the Bankruptcy Act in force until 1978], and for some indefinite time thereafter, it is to be expected that in the aggregate the new securities will sell below the values assigned them in the reorganization.

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OVERVALUATION AND UNDERVALUATION

"The other reason for urging a relatively conservative approach to valuation ... is more basic. Creditors cannot protect themselves against an overvaluation. But the shareholders, once disputes over creditors' claims have been settled, have a means of protecting their interests from an undervaluation of the firm. This they can do by turning to the market for either debt or equity funds to pay off creditors. And if worse comes to worse they can even appeal to the market to buy out both the creditors and their own position.

MORE ON PRIORITY

Priority is determiend not only by statute, but by contract. For example, the creditor who gets a mortgage on the debtor's real property or a security interest on the debtor's equipment and inventory under the Uniform Commercial Code would be paid out of that asset and, usually, become a general unsecured creditor of the company for any deficiency.

FOUR MAJOR SOURCES OF CONFLICT BETWEEN BONDHOLDERS AND STOCKHOLDERS

The bond indenture seeks to govern conflict between the creditors and the stockholders. Bondholders add covenants to the indenture to broker this conflict, in addition to including a risk premium in the interest rate on the bonds.

> **Dividend payment**: The value of the bonds is reduced by the firm's raising the dividend rate and financing the increase by reducing investment. At the limit, if the firm sells all the assets and pays a liquidating dividend to the stockholders, the bondholders are left with worthless claims.
>
> **Claim dilution**: If the firm sells bonds, and the bonds are priced assuming that no additional debt will be issued, the value of the bondholders' claims is reduced by issuing additional debt of the same or higher priority.
>
> **Asset substitution**: If a firm sells bonds for the stated purpose of engaging in low variance projects and the bonds are valued at prices commensurate with that low risk, the value of the stockholders' equity rises and the value of the bondholders' claim is reduced by substituting projects which increase the firm's variance rate (i.e. high risk projects)
>
> **Underinvestment**: A substantial portion of the value of the firm is composed of intangible assets in the form of future investment opportunities. A firm with outstanding bonds can have incentives to reject projects which have a positive NPV if the benefit from accepting the project accrues to the bondholders.

Key to the indenture is also a set of provisions which defines with a high degree of precision the exact course the bondholders, acting individually or together, must pursue in order to levy on the corporation, as general creditors, or to levy on the specific property, if any, set aside for the security of the bonds issued under the indenture.

SUBORDINATION

Subordination is the agreement by the holder of certain debt ("the subordinated debt") that the holder of certain other specified indebtedness of the same debtor ("the senior debt") will receive prior payment in full of that senior debt. It is typically driven by a subordination agreement that specifies payments may be made on the subordinated debt until a specified event, such as bankruptcy, insolvency or liquidation of the debtor, or other voluntary or involuntary distribution of its assets (or, in some cases, default in payment of senior debt) triggers the subordination.

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NEGATIVE PLEDGE CLAUSE

A negative pledge clause is a covenant in the bond indenture that limits the ability of the debtor to borrow money secured by liens on, or through the use of sale and leaseback tranactions affecting, some or all of its property unless the bonds are equally and ratably secured

S 9-401 of the UCC does not prevent the transfer of the debtor's rights in collateral from taking effect when there is an agreement between the debtor and a secured party which prohibts a transfer of the debtor's rights in collateral or makes the transfer a default. However, the debtor's breach may cause a default.

SECURED CREDIT

The property to be secured could be realty or not.

Realty interests are generally governed by state realty mortgage statutes. They set up a local realty filing system, with mortgage priority accorded to the first filer in the realty records.

Non-realty interests (in machinery, inventory, etc.) are governed by Article 9 of the UCC. The UCC sets up a filing and notice system, not all that different from the mortgage system.

A "possessory" security interest (or, "pledge") involves the secured party's taking possession of the collateral. A "nonpossessory" arrangment means that possession is in the debtor.

A "purchase money" security interest, the credit advanced by the secured party enables the debtor to purchase the item covered by the security interest. The purchase money creditor may be either the seller himself, who sells the item on credit to the debtor, or some other party, like a bank, that advances funds to the debtor to be paid to the seller.

A "non-purchase money" security interest is one if the loan is not made to enable the debtor to purchase the collateral. For example, a finance company's advancing funds against an automobile already owned by the debtor.

S 1129(b)(2) of the code says that the requirement that a plan be fair and equitable (and hence confirmable even if the affected creditor dissents and is impaired) includes the following:

(A) With respect to a class of secured claims, the plan provides -

(i) (I) that the holders of such claims retain the liens securing such claims, whether the property subject to such liens is retained by the debtor or transferred to another entity, to the extent of the allowed amount of such claims; and

(i)(II) that such holder of a claim of such class receive on account of such claim deferred cash payments totalling at least the allowed amount of such claim, of a value, as of the effective date of the plan, of at least the value of such holder's interest in the estate's interest in such property;

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SECURED CREDIT

Three sections of the Bankruptcy Code can directly upset an otherwise valid security interest.

A security interest given to a prior creditor on the eve of bankruptcy may be a "preference," one that the bankruptcy trustee can recover. S. 547 of the Code

It could also be a fraudulent conveyance. S. 548 of the Code

It could also be avoided under the strong-arm power of S. 544. If a creditor lends money to the firm and takes a security interest but neglects to perfect the security interest, by, say, neglecting to file the financing statement, the trustee during the bankruptcy can set aside the security interest (even if no real creditor could do so) because the trustee takes on the power of a hypothetically ideal creditor, whether or not such a creditor exists

MARSHALLING DOCTRINE

The marshalling doctrine is classically invoked by junior lienors against a senior lienor having two or more funds from a common debtor from which the senior lienor could be satisfied.

When successfully invoked, the senior lienor must satisfy itself first from the fund against which it alone can claim, thereby freeing up more assets for the junior lienor to levy against. Unsecured creditors usually lose when it is invoked, since more collateral is taken by secured creditors than might be if the assets are not marshalled.

The doctrine has been invoked - not always successfully - by unsecured creditors trying to force a senior creditor to levy against the assets of a guarantor (that has guaranteed the senior's loan, but not the unsecured creditors' loan) before the senior levies on the assets of the common debtor. Veil-piercing alter ego doctrines might link the guarantor with the corporate debtor, thereby negating the marshalling requirement that there be a common debtor

The guarantor usually is subrogated to the guaranteed's claim. (Subrogation allows the guarantor to step into the guaranteed creditor's shoes. The guarantor, once subrogated, can assert the guaranteed secured creditor's security interest.) Thus the guarantor would become a secured creditor claiming against the very pool of collateral that the unsecured creditors would like to obtain for themselves. When inequitable or fraudulent action was taken by the guarantor, the subrogation rights of the guarantor have been subordinated to the unsecured claims.

HOLDING COMPANIES

If debt is lodged in the subsidiary of a company, normally the subsidiary's creditors in a reorganization would get the subsidiary's assets. If the subsidiary is solvent, assets will be left over for the subsidiary's stockholder, which is the parent company. The bankrtupcy plan could distribute those assets as a liquidating dividend of the subsidiary. If the subsidiary were not liquidated, the subsidiary's common stock, which is an asset of the parent company, would be worth something, i.e. the net worth of the subsidiary. If the parent company were also in bankruptcy, that stock would provide value to the parent company's creditors. Only when the parent company's creditors were paid off in full would there be a bankruptcy distribution to the parent company's stockholders.

Veil-piercing allows a creditor to claim directly against the owners of a corporation. It's often employed if the owner misrepresented the corporate status of the business or if the corporate formalities have not been observed. Dividend statutes restrict the dividends that a corporation can pay; the statutes provide remedies that allow the wronged creditors to force the corporation to recover illegal dividends. Fraudulent coneyance law allows the trustee in bankruptcy to recover assets transferred when the corporation was insolvent (if transferred for insufficient consideration) and assets transferred with the intent to delay or defraud the bankrupt company's creditors.

Substantive consolidation disrespects the separate corporate entities, cancels all inter-corporate contracts and claims (including state law fiduciary duty, veil-piercing and fraudulent conveyance claims that one related corporation might have against another).

Consolidated Rock Products

Equity will not permit a holding company, which has dominated and controlled its subsidiaries, to escape or reduce its liability to them by reliance upon self-serving contracts it has imposed on them.

A holding company in a dominating and controlling position has fiduciary duties to security holders of its system which will be strictly enforced.

A holding company owing money to its subsidiaries under an agreement between them can not defeat or postpone an accounting in the interest of their bondholders by resort to a declaration in the agreement that it was made for the benefit of the parties to it, not "for the benefit of any third person"

In view of the unified operation of all the properties by the parent company, the commingling of assets, and the treatment of the subsidiaries as mere departments of its business, that company is in no position to assert that its assets are insulated from the claims of its subsidiaries' bondholders

FRAUDULENT CONVEYANCE

The transfer might be a fraudulent conveyance if the transfer was for inadequate consideration and the firm was rendered insolvent (or was already insolvent). The wronged creditor may attack the recipient of the conveyance, including a recipient such as a parent firm. Pertains to transfers made within a year of filing.

Alternatively, even if the transfer did not render the subsidiary insolvent, but was done with intent to hinder, delay or defraud the creditor, the wronged creditor may attack the transfer. Usually, a single fraudulent transfer from the subsidiary to the parent would not in itself justify substantive consolidation of parent and subsidiary.

VEIL-PIERCING AND CORPORATE WASTE

Sometimes creditors can attack the parent directly. If the parent, as controller of the subsidiary, operated the firm in a way that improperly hurt the subsidiary's creditors, the subsidiary's creditor can claim against the controlling person, the parent. Roughly similarly, the subsidiary could have a direct claim (that the subsidiary's creditors wish the subsidiary to assert) if the subsidiary were so badly run that breach of the duty of care, of the business judgment rule, could be found.

DIVIDEND STATUTES

State corporate statutes regulate the size of the dividends that a corporation can pay. The dividend limitations are roughly similar to limitations on fraudulent conveyances. Insolvents cannot properly pay dividends. In many states, dividends can only be paid out of certain capital accounts. The authorities are mixed as to whether a dividend, if properly paid under the dividend statute, can be attacked under more stringent fraudulent conveyance provisions.

COMPLEX CORPORATE STRUCTURES AND SENIORITY

For a corporate group more complex than that in *Consolidated Rock*, there could have been multiple transfers up and down from parent to subsidiary, from subsidiary to parent, and from one subsidiary to another subsidiary, of assets, opportunities, guarantees and managers. For a court to value each transfer would be hard, expensive and inaccurate.

> ***Augie/Restivo Baking Company, Ltd.***
>
> Rather, substantive consolidation should be used *only* after it has been determined that *all* creditors will benefit because untangling is either impossible or so costly as to consume the assets. Otherwise, … a series of fraudulent conveyances might be viewed as resulting in a "commingling" that justified substantive consolidation. That consolidation, because it would eliminate all inter-company claims, would prevent creditors of the transferor from recovering assets from the transferee.

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PREFERENCES

The trustee may avoid any transfer of an interest of the debtor in property under certain conditions (see S 547 of the Code):

- To or for the benefit of the creditor
- For or on account of an antecedent debt owed by the debtor before such transfer was made
- Made while the debtor was insolvent
- Made on or within 90 days before the date of filing (or 1 year if such creditor at the time was an insider)
- Enables the creditor to receive more than they would if
  - The case were a case under Chapter 7
  - The transfer had not been made
  - Such creditor received payment of such debt to the extent provided by the provisions of this title

Insiders include directors, officer or persons in control of the debtor; a creditor is anyone with a claim against the debtor

- This means that a Guarantor is a creditor to the debtor in that the lender can collect from the Guarantor
  - Guarantor then steps into Lender's shoes

If avoided, the preference is recoverable from the initial transferee or the entity for whose benefit such transfer was made, or any immediate or mediate transferee of such initial transferee, if it was not made in good faith

- If the Guarantor is deemed to be an insider, then a Lender could be on the hook for up to a year pre-filing
  - Insiders frequently guarantee loans --> inducing the firm to pay the lenders early benefits the guarantor

The trustee's avoiding power is essential to making the bankruptcy case a collective proceeding

- It eliminates the benefit of attaching assets out of the ordinary course in the last 90 days before the filing
  - The rush to dismember a firm is not profitable from the creditor's perspective
- It assures each creditor that if it refrains from acting, the pickings of anyone less civil will be put back into the pool

A preference is only a preference ***to the extent*** that the creditor got more than it would have received in a liquidation

It is not avoidable if the transfer was intended by the debtor and the benefiting creditor to be a contemporaneous exchange for new value given to the debotr and in fact a substantially contemporaneous exchange

- Or if it was in the ordinary course
- Or if it was a security interest in property acquired by the debtor (purchase money interest)

S 546 denies the trustee poewr to avoid some transfers that it could otherwise avoid under S 544. S 546 says that the trustee *cannot* set aside an incomplete security interest *if* state law allows subsequent completion of the security interest to beat creditors that lent before the security interest was completed. So, if the secured creditor is lending in a *state* that gives the secured creditor a 20-day grace period for filing, then S 546(b) says the trustee *cannot* use S 544 to set aside the security interest. (Many states give 10 days via UCC S 9-301(2); some give more.) And the stay is lifted to allowing the creditor to rush to file within the 20 days even if there is an intervening bankruptcy.

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EQUITABLE SUBORDINATION

If a creditor also controls the debtor-subsidiary as its stockholder, problems arise. The controlling creditor could manipulate the debtor's business to its own advantage as creditor, to the detriment of other creditors. If this is the case, then the claims of the controlling creditor should be subordinated to the claims of other creditors, in the interests of equity.

> A claim is generally subordinated only if the holder of such claim is guilty of inequitable conduct, or the claim itself is of a status suceptible to subordination, such as a penalty or a claim for damages arising from the purchase or sale of a security of the debtor. [See rescission, below.] The fact that such a claim may be secured is of no consequence to the issue of subordination. It is inconceivable that the status of a claim as a secured claim could ever be grounds for justifying equitable subordination.

RESCISSION

Under S 510 of the Code (as amended in 1978), a claim arising from rescission of a purchase or sale of a security of the debtor or an affiliate of the debtor … shal be subordinated to all calims or interests that are senior to or equal the claim or interest represented by such security, except that if such security is common stock, such claim has the same priority as common stock. Nothing shall prevent equitable subordination from being applied, as appropriate.

REJECTING PRE-BANKRUPTCY CONTRACTS

The Code allows the bankrupt to affirm or reject executory contracts - those contracts for which neither side has substantially peformed its obligation under the contract. Upon rejection, the nonbankrupt party obtains a claim in banrkuptcy, and shares with the bankrupt's other creditors.

> The claim under this S 365 rejection is the same as if such claim had arisen before the date of the filing of the petition. However, the claim is a general unsecured claim.
>
> The Code takes an all-or-nothing approach to executory contracts mandating that the bankrupt must assume the burdens of the contract along with the benefits; it cannot cherry-pick the contract for its most favorable aspects. Once it affirms the entire contract, the bankrupt must pay any of the missed partial installments.
>
> S 365 has 3 important caveats.
>
> > The nonbankrupt entity cannot take advantage of an ipso facto clause, ie a clause that allows the nonbankrupt to opt out of a contract just because the bankrupt has filed for bankruptcy. Once the debtor assumes the contract, it need not cure the breach of an ipso facto clause.
> >
> > If the contract has penalty rates that arise from a bankrupt's failure to perform, the penalty is not enforceable against the bankrupt.
> >
> > The bankrupt can assign contracts and leases, notwithstanding that the contract or lease bars assignment.

Generally (with the exception of commercial leases that must be accepted or rejected in 60 days), the bankrupt has until the confirmation of the plan to assume or reject.

BANKRUPTCY CODE SUMMARY Chapter 11 entails a renegotiation among creditors, managers and stockholders.

REJECTING PRE-BANKRUPTCY CONTRACTS

If the contract has a specific performance clause and the bankrupt rejects the contract, then the value of the specific performance clause must be converted into a dollar amount.

LABOR CONTRACTS

The Code limits the bankrupt's authority to reject one type of long-term supply agreement, that for labor supplied under union contracts

Bankrupt must first negotiate with the union, by proposing modifications necessary to permit reorg and assures that all creditors, the debtor and all of the affected parties are treated fairly and equitably.

Bankrupt must provide the union with the information necessary for the union to evaluate whether the proposal meets the S 1113 standards.

If the union rejects, the court may allow the bankrupt to reject the union contract, if its concludes that union rejection was without good cause and "the balance of the equities clearly favors rejection …"

INTEREST

Distribution of property is spelled out in S 726 (for Chapter 7 liquidations), if the estate is solvent

1. Administrative and priority claims
2. Allowed unsecured claims
3. Allowed unsecured claims proof of which is tardily filed
4. Payment of certain fines
5. Payment of interest at the legal rate from the date of filing of the petition on any claims under 1-4
6. To the debtor

Potential conflicts of interest over post-petition interest payments in bankruptcy include

1. Do creditors get post-petition interest before stockholders get anything?
2. For an insolvent company, do seniors get post-petition interest before junior creditors get anything?
3. Do secured creditors get interest before unsecured creditors get principal?
4. For insolvent bankrupts, do creditors with a high coupon do better than those with a low coupon?
5. Do guarantors have to make good on a creditor's claim for post-petition interest even when the Code disallows interest?

S 502(b)(2) provides that a claim for post-petition interest is not allowed, ie not part of the allowed claim referred to in 1129(b)(2)'s cramdown requirements that the holders of the impaired class of unsecured claims either receive property having a value at least equal to the allowed amount of their claims OR that no class junior to the dissenting class will receive any distribution under the plan

However, courts have held that where an estate is solvent, in order for a plan to be fair and equitable, unsecured and undersecured creditors' claims must be paid in full, including post-petition interest, before equity holders may participate in any recovery

BANKRUPTCY CODE SUMMARY Chapter 11 entails a renegotiation among creditors, managers and stockholders.

INTEREST

With respect to the issue of senior vs juniors,

> ***King Resources***
> Where the subordinating provisions are unclear or ambiguous as to whether post-petition interest is to be allowed a senior creditor, the general rule that interest stops on the date of the filing of the petition in bankruptcy is to be followed

A subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under non-bankruptcy law (S 510(a)

Where the guarantee provides that the guarantee shall not be impaired by the obligor filing for bankruptcy, the creditor would be entitled to post-petition interest from the guarantor; the guarantor would be subrogated into the creditor's shoes and bankruptcy would eliminate the now subrogated guarantor's right to post-petition interest

ADEQUATE PROTECTION

S 506(b) benefits the oversecured creditor by allowing the holder of such claim to receive interest on such claim

> S 362(d) assures the secured creditor of adequate protection. If not adequately protected, the secured creditor is entitled to relief from the stay (ie creditor could seize the property)

Adequate protection is protection only against the deterioration of the value of their collateral

Oversecured --> AP
If way oversecured --> r
Undersecured --> AP a r

S 506 has the substantive effect of denying undersecured creditors postpetition interest on their claims, just as it denies oversecured creditors postpetition interest to the extent that such interest when added to the principal amount of the claim will exceed the value of the collateral

S 506 permits post-petition interest to be paid only out of the "security cushion", the undersecured creditor, who has no such cushion, falls within the general rule disallowing postpetition interest. It has been considered unfair in the case law to allow an undersecured creditor to recover interest from the estate's unencumbered assets before unsecured creditors had recovered any principal.

> ***Timbers***
> "The Fifth Circuit correctly held that the undersecured petitioner is not entitled to interest on its collateral during the stay to assure adequate protection under 11 U.S.C. S 362(d)(1) ..."

Courts usually use the rate set statutorily by each state to be paid on judgments of its courts as the "legal rate"

Under S 1124(2), a creditor is deemed uniimpaired if its claim is reinstated and damages paid for missed payments.

> S 1123(d), in the context of interest on interest, a proposal in the plan to cure a default, then the amount necessary to cure the default shall be determined in accordance with the underlying agreement and applicable nonbankruptcy law. The intention was to put the debtor in the same position as if the default had never occurred, in order to avoid any court-contrived windfall to the creditor. So if and only if the underlying agreement and applicable nonbankruptcy law permit it, the debtor may have to pay interest on interest.

BANKRUPTCY CODE SUMMARY Chapter 11 entails a renegotiation among creditors, managers and stockholders.

INTEREST

New York law prohibits the payment of interest on interest, for example unless it is for commercial loans larger than $250,000

HOLDOUTS AND THE BUOYING-UP EFFECT IN WORKOUTS

When the firm is shaky, those bondholders that do not exchange their bonds will be enriched at the expense of the exchanging bondholders. As long as that subsidy to the holdouts is greater than the savings in avoided bankruptcy costs accruing to potential exchanging bondholders, the potentially exchanging bondholders are better off holding out. Recognizing this, those that want to exchange condition their willingness to participate on others also exchanging.

Recall the legal practitioner's simple admonition to creditors against "losing priority" in a recapitalization and that the principle of "equality of sacrifice" should govern a workout

Ways to get around the holdout problem include

Covenant stripping to make the holdout's bonds less valuable
Coming up with a post-exchange structure that eliminates the holdout benefit and reduces the value of holdout bonds, say with additional seniority or security

For exit consent exchange offers for diffusely distributed bonds of healthy firms, the buoying-up effect could easily be less than the coercive effect.

There are two trigger points: the amount needed to amend the bond indenture (typically a simple majority or two-thirds) and the amount needed to effectuate an exchange offer, which for a distressed company is typically 80-90%

ORIGINAL ISSUE DISCOUNT

Interest disallowed under S 502(b)(2) includes post-petition interest that is not yet due and payable, ie OID

Chateaugay

Situation: Old Debt Securities with an OID exchanged for New Debt Securities and Common
Allowed Claim: Fair Market Value of old debt securities on the exchange date plus that amount of OID amortized prior to filing date

LTV

An exchange of old debt for new debt with the same face value but an OID on the new debt to reflect the marked down price of the old debt (a "face value exchange") creates an OID that is not allowable as part of the claim

no AP necess
return of pri