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Chapter 11 Plan, Exclusivity and its Timing, as well as other Significant Reorganization Aspects Affected by the New Amendments to the Bankruptcy Code

Lost in the publicity surrounding the legislation is the fact that certain of the Reform Act amends the Bankruptcy Code in ways that likely will directly and profoundly impact business reorganizations under Chapter 11 of the Bankruptcy Code. This memorandum is divided into two parts. In the first part, it provides a general overview of Chapter 11 and certain of the provisions of the Reform Act that are relevant to Chapter 11 cases.¹ In the second part, the memorandum briefly discusses how select provisions of the Reform Act may impact practice under Chapter 11 of the Bankruptcy Code.

I. Overview of Chapter 11.

A. Introduction.

Chapter 11 of the Bankruptcy Code² is the general business reorganization chapter of the Bankruptcy Code. It stands in stark contrast to Chapter 7, which provides a statutory scheme to liquidate in bankruptcy.³ It is well settled that

[t]he purpose of a [Chapter 11] business reorganization case, unlike a [Chapter 7] liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors and provide a return for its stockholders. The premise of a business

reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.⁴

There is no specific event that requires an entity in the United States to seek bankruptcy protection. An entity is not compelled to seek bankruptcy protection if it becomes insolvent, nor is insolvency a requirement for an entity to voluntarily file for bankruptcy protection. Instead, the precipitating event for the most corporate bankruptcies in the United States is a lack of sufficient liquidity to fund ongoing operations or otherwise pay debts as they come due, although at times bankruptcy is used by a company to clean up its balance sheet in advance of a liquidity crisis. Accordingly, in the United States, companies with a negative shareholders' equity may continue operating outside of bankruptcy and companies that are solvent from a balance sheet perspective may seek bankruptcy protection.

¹ This memorandum will highlight those provisions that likely will most significantly impact Chapter 11 cases.

² 11 U.S.C. §§ 1101-1146.

³ 11 U.S.C. §§ 701-784.

⁴ H.R. Rep. 595, 95th Cong., 1st Sess. 220 (1977).

The loss of trade support and customer confidence often will hasten the company's decision to seek bankruptcy protection. Although it may seem counterintuitive, as described in greater detail below, a company's ability to obtain liquidity both in the form of new loans and trade credit typically improves following the filing of a bankruptcy petition. The longer the decision to file a Chapter 11 petition is delayed during a period where a company is experiencing a decline in trade support and customer confidence, the greater the risk is that a troubled company's business will be harmed significantly through the permanent defection of customers.

As is more fully discussed below, the impact of the Reform Act likely will be felt at different points throughout the workout and Chapter 11 process. Accordingly, (i) proper pre-bankruptcy planning and negotiations will be paramount, (ii) once in Chapter 11, a company's ability to operate its business may be more limited than under existing law and (iii) the increase in claims entitled to administrative priority status and the change in the treatment of tax claims could give rise to difficulties in plan confirmation.

The impact of the Reform Act on the Chapter 11 process will depend, in part, on the nature of the underlying business of the distressed company. Significant changes in current practice and procedure will likely be seen in retail and manufacturing cases – businesses with substantial non-residential leasehold property interests and utility requirements, and large numbers of employees and trade suppliers (*e.g.*, Winn-Dixie Stores, Spiegel, Interstate Bakeries). Fewer changes will be evident in cases involving hi-tech companies and service providers, whose assets tend to be primarily infrastructure, intellectual property and customer contracts, and tend to have fewer employees and trade vendors (*e.g.*, Asia Global Crossing). Moreover, the impact of the Reform Act will vary with type of approach to Chapter 11 that is being taken. So-called “free fall” cases, *i.e.*, cases that utilize Chapter 11 primarily for its debtor protections to gain a respite from creditors in order to implement new business strategies while developing a reorganization plan for creditors, may be significantly affected, particularly by the limits on plan

exclusivity and key employee retention and severance programs. Pre-packaged and pre-negotiated cases centering on new equity investment, debt for equity swaps, or Section 363 sales of significant assets likely will see fewer changes due to the Reform Act.

B. Commencement of a Chapter 11 Case.

The vast majority of bankruptcies in the United States are brought voluntarily under Chapter 11. The filing of a voluntary Chapter 11 petition by a company instantaneously affords it the benefits and protections of the Bankruptcy Code without further order of the bankruptcy court. Although the act of filing a Chapter 11 petition is relatively ministerial in nature, a smooth transition into Chapter 11 is dependent upon obtaining additional relief from the bankruptcy court immediately after the filing. Accordingly, advanced planning for a Chapter 11 filing often is critical.⁵

As explained below, there is a presumption that upon the commencement of a Chapter 11 case, the debtor's business will continue to operate. In order to avoid (or at least minimize) the disruption to a debtor's business upon filing for bankruptcy, the bankruptcy court will often grant relief to a debtor by approving certain “first day

⁵ In addition to voluntary Chapter 11 petitions filed by the debtor company, creditors have the right, under certain specific circumstances, to file an involuntary petition under Chapter 11. In order to file an involuntary bankruptcy case, three or more creditors must join in the petition and their claims must aggregate at least \$11,625 of unsecured debt. A creditor's claims for unsecured debt cannot be contingent, or the subject of a bona fide dispute. A debtor may contest an involuntary petition filed against it. In order for creditors to avoid the dismissal of their involuntary petition, they must establish that either (1) the debtor is generally not paying its debts as they become due or (2) a custodian or receiver has been appointed with regard to the debtor's property within 120 days before the involuntary petition was filed. Even if one of these grounds is established, the bankruptcy court still has the discretion to dismiss a petition if, in its view, the interests of all creditors and the debtor would better be served by dismissal. If an involuntary petition is dismissed, and it is found that cause was lacking for the filing of the petition, the bankruptcy court may impose upon the filing parties the debtor's fees and costs in defending against the petition, as well as consequential and punitive damages. In the case of a public company, such damages could be measured in the tens, if not hundreds, of millions of dollars. See 11 U.S.C. § 303.

motions” pursuant to the bankruptcy court’s equitable powers under the Bankruptcy Code Section 105(a), and the judicially-created “necessity of payment rule.” The first day motions are generally entered after being served on the thirty largest creditors, major pre-petition lenders and the United States Trustee. Below is a list of significant first day motions and the impact the Reform Act has on such motions.

1. Motion pursuant to Sections 105(a) and 363(b) to pay pre-petition employee wages and continue employee benefit programs. Section 507 of the Bankruptcy Code accords priority treatment to a select group of creditors holding unsecured claims against the debtor. One such group is comprised of the debtor’s employees who are accorded limited administrative priority treatment for unpaid pre-petition wages, salaries and commissions, including vacation, severance and sick pay.⁶ The priority is limited to unpaid wages, salaries, etc. earned during the 90-day period immediately preceding the filing of the Chapter 11 petition and is capped at \$4,925.⁷ Frequently, at the outset of a case, the debtor will request leave to pay those claims in order to avoid imposing undue hardship on employees, damage to employee morale and untimely departure of irate employees.

- a. The Reform Act amends Section 507 to expand the scope of the priority. First it extends the time period from 90 to 180 days before the earlier of the petition date or the date the debtor ceased business the period within which unsecured claims for earned wages, salaries and commissions, including vacation, severance and sick leave are entitled to administrative priority treatment. Second, it increases the amount of the claim from \$4,925 to a maximum of

\$10,000.⁸ Note, the amendment is effective for all cases filed after April 21, 2005.

- b. Section 1114 of the Bankruptcy Code regulates the payment of insurance benefits to retired employees. The Reform Act amends Section 1114 to provide that if a debtor modified retiree benefits during the 180-day period prior to the bankruptcy filing and was insolvent at such time, the bankruptcy court will, upon motion of a party in interest, reinstate such benefits as of the date of modification unless the bankruptcy court finds that the modification was equitable.⁹ Note, the amendment is effective for all cases filed after April 21, 2005.

2. Motion pursuant to Sections 105(a) and 364 of the Bankruptcy Code authorizing maintenance of existing bank accounts, cash management systems and continued use of existing business forms. The motion seeks the bankruptcy court’s permission to continue to use existing bank accounts and cash management systems, minimizing disruption to operations.

3. Motion pursuant to Sections 363 and 364 of the Bankruptcy Code authorizing the use of cash collateral and/or obtain “debtor-in-possession,” or DIP, financing. This motion seeks permission from the bankruptcy court to obtain “debtor-in-possession” financing and to use cash that is subject to the security interests of pre-petition creditors on an interim basis pending a final hearing. Once a Chapter 11 case has been filed, the debtor may obtain financing on relatively favorable terms. A principal benefit of Chapter 11 is the access to liquidity that was not present prior to the filing of the case. The Bankruptcy Code, Section 364, authorizes a debtor, subject to bankruptcy court approval, to obtain financing either on a secured or superpriority basis. The superpriority claim would permit the lender to be repaid

⁶ 11 U.S.C. § 507(a)(4).

⁷ 11 U.S.C. § 507(a)(3).

⁸ 11 U.S.C. § 507(a)(4) (as amended).

⁹ 11 U.S.C. § 1114(l) (as amended).

ahead of all other creditors, except those with pre-existing liens on collateral. Debtor-in-possession financing should be negotiated prior to the bankruptcy filing and sought on an interim basis as part of the first day motions.

- a. Although there were no direct changes to Section 364 in the Reform Act, the changes to the Code on a collective basis will affect how a debtor “sizes” its debtor-in-possession financing. The debtor will have to consider the amendments to the provisions relating to the utility companies, reclamation and leases when determining how much liquidity is needed for the bankruptcy case.

4. Motion authorizing payment of key suppliers. This motion seeks permission for the debtor to continue payments to a key supplier in order to ensure continued deliveries from such supplier.

5. Motion to pay customs duties, taxes and tariffs. This motion seeks permission for the debtor to pay pre-petition charges related to the importation of goods to ensure that delivery of goods is not interrupted.

6. Motion Pursuant to Sections 105(a) and 366(b) of the Bankruptcy Code determining that adequate assurance has been provided to the utility companies. Section 366 of the Bankruptcy Code governs the rights of a utility to alter, refuse or discontinue service to a debtor.¹⁰ In substance, it provides that within the first 20 days after the commencement of a case, a utility may not alter, refuse or discontinue service to, or discriminate against, a debtor on the basis of the commencement of the case or the nonpayment of a pre-petition debt.¹¹ Thereafter, the utility may only alter, refuse or discontinue service if the debtor does not furnish the utility with adequate assurance of future payment.¹² The section is self-executing. As such, if the debtor and utility can agree upon the adequate

assurance, a proceeding in court is not required. Where the utility and debtor cannot reach agreement, the bankruptcy court, after “notice and a hearing” can modify the amount of deposit or other security requested.¹³ A debtor frequently seeks to fix relief in the early stages of the case pursuant to a “first day motion.” Although the statute requires the debtor to furnish “adequate assurance of payment in the form of a deposit or other security,”¹⁴ it further provides that the “court may order reasonable modification of the amount of the deposit or other security necessary to provide adequate assurance of payment.”¹⁵ Some courts have interpreted that provision to mean that no deposit or financial accommodation is required under Section 366 if the debtor can show sufficient resources to meet anticipated administrative expenses (either through debtor-in-possession financing or sufficient cash reserves) and a good payment history.¹⁶

- a. The Reform Act amends Section 366 to permit a utility to alter, refuse or discontinue service to a Chapter 11 debtor if the utility does not receive, within 30 days after the bankruptcy filing, adequate assurance of payment “that is satisfactory to the utility.”¹⁷ The Reform Act defines “adequate assurances” as (i) a cash deposit, (ii) a letter of credit, (iii) a certificate of deposit, (iv) a surety bond, (v) a prepayment for utility consumption or (vi) some other form of security agreed to by the debtor and the utility.¹⁸ Although, as amended, Section 366 gives the bankruptcy court the power to modify the form of adequate assurance, it cannot base such a modification on the debtor’s pre-petition payment history, the

¹⁰ 11 U.S.C. § 366.

¹¹ 11 U.S.C. § 366(a), (b).

¹² 11 U.S.C. § 366(b).

¹³ 11 U.S.C. § 366(b).

¹⁴ 11 U.S.C. § 366(b).

¹⁵ *Id.*

¹⁶ See, e.g., *Virginia Electric & Power Co. v. Caldor*, 117 F.3d 646, 650-51 (2d Cir. 1997).

¹⁷ 11 U.S.C. § 366(c)(2) (as amended).

¹⁸ 11 U.S.C. § 366(c)(1) (as amended).

debtor's timely payment of utility charges or the availability of administrative expense priority.¹⁹

7. Motion pursuant to Sections 327 and 328 of the Bankruptcy Code to retain attorneys, accountants and financial advisors. This motion seeks permission to retain counsel and other advisors. Section 328 of the Bankruptcy Code presently provides that a debtor can retain an advisor on any reasonable terms and conditions including on a retainer on an hourly basis or on a contingent fee basis.²⁰

- a. The Reform Act amends Section 328 to add "on a fixed or percentage fee basis" as a reasonable term or condition upon which a professional can be retained.²¹

8. In large, complicated Chapter 11 cases, it is common for the debtor to retain investment bankers, as well as legal and accounting advisors. Such professional cannot be retained to represent a Chapter 11 debtor if it holds or represents an interest adverse to the estate, or is not a "disinterested person."²² Under current law, a "disinterested person" excludes (i) an investment banker for any outstanding security of the debtor, or (ii) an investment banker (or its counsel) in connection with the offer, sale or issuance of such security within three years of the filing of the Chapter 11 petition.²³

- a. The Reform Act repeals those per se disqualifications. It amends the definition of "disinterested person" to delete all references to investment bankers.²⁴

9. Motion pursuant to Sections 105(a) and 363(b) of the Bankruptcy Code to enter into retention agreements

with certain key employees and pay retention bonuses to certain secured employees. In furtherance of the operation of its business debtors frequently seek court authority to implement Key Employee Retention Programs ("KERPs"). The rationale for implementing KERPs is that they are necessary to ensure that the debtor will be able to retain key managers during the Chapter 11 case, all for the benefit of the debtor, its creditors and estate. The Bankruptcy Code did not specifically address KERPs.

- a. The Reform Act amends Section 503 of the Bankruptcy Code to address specifically the facts and circumstances under which KERPs are permitted.²⁵ In summary, the Reform Act amends the Bankruptcy Code, as follows:

1. Limits on Key Employee Retention Plans (KERPs) and Severance Payments

- a. No stay bonus - transfers or obligations to an insider (*i.e.*, officers) designed to induce the insider to remain with the business are prohibited unless court finds:
 - i. The transfer or obligation is essential to retention of the insider because of a bona fide competing job offer at the same or greater rate of compensation; and
 - ii. The services of the insider are essential to the survival of the business and the amount of the payment is not greater than 10x mean transfer or obligation of a similar kind given to non-management employees for any purpose during the prior calendar year; or if no such amounts, not greater than 25% of the amount of any similar transfer or obligation to such insider for any purpose during the prior calendar year.
- b. No severance payments to an insider unless:

¹⁹ 11 U.S.C. § 366(c)(3) (as amended).

²⁰ 11 U.S.C. § 328(a).

²¹ 11 U.S.C. § 328(a) (as amended).

²² 11 U.S.C. § 327.

²³ 11 U.S.C. § 101(14)(B)(C).

²⁴ 11 U.S.C. § 101(14) (as amended).

²⁵ 11 U.S.C. § 503(c) (as amended).

- i. The payment is part of program generally applicable to all full-time employees; and
 - ii. The amount of payment not greater than 10x the mean severance payment given to non-management employees during the prior calendar year.
- c. Pre-petition avoidance: The Reform Act specifically add transfers to an insider under an employment contract not in the ordinary course of business, for a period of two years prior to the petition date, to the general list of transfers that may be avoided as a fraudulent conveyance.
 - i. Eliminates insolvency as a criterion; such non-ordinary course transfers under employment contracts are avoidable regardless of debtor's financial condition.
- d. Post-petition transfers to officers, managers or consultants hired after the petition date outside the ordinary course of business and not justified by the "facts and circumstances of the case" are not allowed.
 - i. The Reform Act codifies the existing practice of seeking court approval for significant post-petition hires, including the retention of senior officers from turnaround consulting and crisis management firms.

C. Control of the Company.

Recognizing that a forced liquidation of a going concern typically does not maximize value, Chapter 11 of the Bankruptcy Code provides a vehicle through which a company can reorganize its business and capital structure while continuing normal operations. Thus, unlike bankruptcies under Chapter 7 of the Bankruptcy Code, and bankruptcies under the laws of many non-U.S.

jurisdictions, a trustee is not appointed to liquidate the debtor's business. Rather, under Chapter 11, there is a presumption that the debtor's business will continue to operate²⁶ and that the debtor will remain in possession and control of its assets as a "debtor in possession."²⁷ Although the debtor's board and management have an almost exclusive ability to make decisions in the ordinary course of business, decisions with respect to actions outside of the ordinary course of business require bankruptcy court approval on notice to creditors, who typically have the right to appear in front of the bankruptcy court and object to the approval of the decision.²⁸

Inasmuch as a debtor continues in possession of its businesses and properties during a Chapter 11 case, the debtor's pre-bankruptcy management continues to operate the company under the supervision of its board of directors. In addition, while in Chapter 11, the debtor's shareholders maintain the right to call meetings and vote their shares.²⁹ While in Chapter 11, the board of directors continues to hold regular meetings and set corporate and strategic policies. It is important to note that, while continuing in much the same capacity, the board's fiduciary obligations to its equity holders are expanded in a Chapter 11 proceeding to encompass creditors. This means that the board can no longer act in the exclusive best interests of the corporation and its shareholders, but instead must also consider the best interests of its creditors.

Notwithstanding the presumption that a debtor will remain in possession and control of its business and assets, a bankruptcy court, *sua sponte*, or on the request of an interested third party, can appoint a trustee (the "Chapter 11 Trustee") to assume control of the debtor in possession's operations, to the exclusion of the debtor's

²⁶ 11 U.S.C. § 1108.

²⁷ 11 U.S.C. § 1101(1).

²⁸ 11 U.S.C. § 363.

²⁹ There is a possibility that under rare circumstances the bankruptcy court will restrict the rights of shareholders if it believes that they unduly will interfere with the conduct of the debtor's Chapter 11 cases.

board of directors and management. The appointment of a Chapter 11 Trustee is a relatively unusual event. It is governed by Section 1104 of the Bankruptcy Code, which provides, in relevant part, that at any time after the petition date but before confirmation of a plan, the bankruptcy court, on request of a party in interest, shall order the appointment of a trustee -

(1) for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause, but not including the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor; or

(2) if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor.³⁰

The Reform Act amends Section 1104 in two principle respects. First, the statute includes an additional basis for mandating the appointment of a Chapter 11 Trustee. As amended, the statute provides that “if grounds exist to convert or dismiss the case under Section 1112, but the court determines that the appointment of a trustee or examiner is in the best interests of the creditors and the estate” then the bankruptcy court shall appoint a trustee or examiner.³¹ Second, the statute now mandates that the U.S. Trustee move for the appointment of a Chapter 11 Trustee “if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor’s chief executive or financial officer, or members of the governing body who selected the debtor’s chief executive or chief financial officer, participated in actual

fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor’s public financial reporting.”³²

D. The Plan of Reorganization.

In order to emerge from Chapter 11, a debtor must obtain court approval or “confirmation” of a plan of reorganization. Under present law, the debtor has the exclusive right to file a plan of reorganization within the first 120 days from the filing of the bankruptcy petition. This time period, however, may be extended by the bankruptcy court and typically is extended for larger corporate debtors. Once the debtor’s exclusive period (including any extensions) has expired, any party in interest may file a plan of reorganization.

The Reform Act amends Section 1121 to provide (i) that the 120-day exclusive period for filing a plan cannot be extended beyond a date that is 18 months after the petition date and (ii) that the 180-day period for soliciting acceptances to the plan cannot be extended beyond a date that is 20 months after the petition date.³³

The plan of reorganization will classify all claims against the debtor and set forth, by class, the treatment of all those claims. Holders of claims and equity interests vote by class either to accept or reject the plan. Prior to voting, each class must receive a written disclosure statement approved by the bankruptcy court containing “adequate information,” *i.e.*, information sufficient for the holders of claims and equity interests to make an informed judgment about the plan.³⁴ The preparation of the disclosure statement, which is very similar to a registration statement that would be filed with the U.S. Securities and Exchange Commission (“SEC”), can be time consuming and arduous because drafts are generally circulated to the Creditors’ Committee and other committees before being submitted to the bankruptcy court.

³⁰ 11 U.S.C. § 1104(a).

³¹ 11 U.S.C. § 1104(a)(3) (as amended).

³² 11 U.S.C. § 1104(e) (as amended).

³³ 11 U.S.C. § 1121(d)(2)(B) (as amended).

³⁴ 11 U.S.C. § 1125.

The Reform Act amends Section 1125 to provide that in determining whether a disclosure statement contains “adequate information,” the bankruptcy court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information.³⁵

1. Voting on the Plan of Reorganization.

All impaired classes are entitled to vote on the plan of reorganization. With respect to each class of creditors, an affirmative vote of at least two-thirds in dollar amount of claims and more than one-half in number of the creditors in a class that submit votes is required for the acceptance of that plan of reorganization by that class. The affirmative vote of equity interest holders holding at least two-thirds in amount of the equity interests in a class is required from the class of equity interest holders voting on the plan of reorganization for acceptance of the plan of reorganization by that class. Classes of claims and equity interests that will not receive any distribution under the plan of reorganization are deemed to have rejected the plan of reorganization and, therefore, do not vote.

2. Cramdown; Absolute Priority Rule.

Upon confirmation of a plan of reorganization, the plan of reorganization is binding on all creditors. Dissenting creditors, however, are entitled to certain minimal standards of treatment under the plan of reorganization before the bankruptcy court may confirm it, even with the majority of the dissenting creditors’ classes having voted in favor of the plan of reorganization. Most importantly, absent consent to lesser treatment, each creditor must receive at least as much in the Chapter 11 reorganization as it would receive in a Chapter 7 liquidation of the debtor.

If a plan of reorganization does not receive the affirmative vote of all classes, it may still be confirmed by the bankruptcy court through a procedure referred to as “cramdown.” To

qualify for cramdown, at least one impaired class of creditors must accept the plan, without counting insiders. Under the cramdown provisions of the Bankruptcy Code, the bankruptcy court may confirm a plan of reorganization lacking the requisite vote in amount and number of an impaired class of claims or interests, if, with respect to each such non-accepting class, the plan does not “discriminate unfairly,” and is “fair and equitable.”

A plan of reorganization does not discriminate unfairly if it treats all similarly situated creditors and equity holders identically. The Bankruptcy Code sets out certain requirements that must be met for a plan of reorganization to be fair and equitable. With respect to a class of secured creditors that votes against the plan of reorganization, the plan of reorganization must provide that (a) each secured creditor retains its lien and receives deferred cash payments in an aggregate amount at least equal to the amount of its allowed claim and of a present value equal to the value of the allowed claim or (b) the creditor receives the “indubitable equivalent” of its claim. For a class of unsecured creditors rejecting the plan of reorganization, the plan of reorganization must provide that (a) each unsecured creditor in such class receives property of a value equal to the allowed amount of its claim or (b) if the creditor does not receive the full amount of its allowed claim, the claim must be paid in accordance with its “absolute priority,” meaning that no holder of a claim or interest junior to such a class of unsecured creditors can receive or retain any property on account of such junior claim or interest.

3. Confirmation Requirements.

The plan of reorganization must meet each of the standards in Section 1129 of the Bankruptcy Code and in general, must provide each class of claims and interests with a recovery that is somewhere between the estates going concern value and liquidation value. See H.R. REP. NO. 595, 95th Cong., 1st Sess. 224 (1997). Section 1129 provides that a plan of reorganization must:

1. Classify all claims and interests other than administrative priority claims and priority tax claims.

³⁵ 11 U.S.C. § 1125(a)(1) (as amended).

2. Specify any class of claims or interests that is not impaired under the plan of reorganization.
3. Provide for the same treatment for each claim or interest of a particular class, unless the holder of a particular claim or interest agrees to less favorable treatment of that particular claim or interest.
4. Provide adequate means for the plan of reorganization's implementation (*e.g.*, debtor's retention of property of the estate, sale of property of the estate free and clear of liens, merger or consolidation of the debtor with one or more entities, satisfaction or modification of any liens, cancellation or modification of any indenture, cure of contract defaults, amendments of charter and/or other corporate documents, extensions of a maturity date or change in the interest rate or other term of outstanding securities).
5. Provides that the reorganized debtor cannot issue "non-voting" stock.

Among other things, a plan of reorganization may:

1. Provide for releases of the debtor's directors and officers.
2. Impair or leave unimpaired any class of claims or interests.
3. Provide for the assumption, assumption and assignment, or rejection of any executory contract or unexpired lease of the debtor not previously rejected.
4. Provide for the settlement or adjustment of any claim or interest belonging to the debtor or its estate.
5. Provide for the sale of substantially all of the property of the estate and the distribution of the proceeds among holders of claims or interests.

The Bankruptcy Code contains specific provisions regarding the satisfaction of tax claims. In relevant part, Section 1129 provides that allowed unsecured claims of governmental units "receive on account of such claim deferred cash payments, over a period not to exceed six years after the date of assessment of such claim, of a value

as of the effective date of the plan equal to the allowed amount of such claim."³⁶

The Reform Act amends Section 1129(a)(9)(C) in three significant ways. First, governmental units holding allowed unsecured claims must receive on account of such claim, regular installment payments in cash "of a value as of the effective date of the plan, equal to the allowed amount of such claim."³⁷ Next, payments to taxing authorities must be completed within five years after the petition date (rather than six years from assessment).³⁸ Finally, the taxing authority must be paid in a manner not less favorable than other non-priority unsecured claims provided for by the plan (other than cash payments to a convenience class).³⁹ Finally, taxing authorities holding secured claims that would otherwise meet the description of unsecured priority tax claims will be entitled to cash payments in the same manner as the unsecured priority tax claims.⁴⁰

4. Confirmation of the Plan of Reorganization.

Once voting on a plan of reorganization is completed, the plan of reorganization is submitted to the bankruptcy court for review and confirmation. In addition to the other requirements discussed above, the bankruptcy court must be satisfied that the plan is feasible prior to confirming the plan of reorganization. The bankruptcy court's inquiry into feasibility will focus on whether the debtor will be able to meet all of its obligations under the plan of reorganization.

Upon the entry of an order confirming the plan of reorganization, all interests (including the interests of those creditors or equity interest holders that voted against the plan of reorganization) are bound by its terms

³⁶ 11 U.S.C. § 1129(a)(9)(C).

³⁷ 11 U.S.C. § 1129(a)(9)(C)(i) (as amended).

³⁸ 11 U.S.C. § 1129(a)(9)(C)(ii) (as amended).

³⁹ 11 U.S.C. § 1129(a)(9)(C)(iii) (as amended).

⁴⁰ 11 U.S.C. § 1129(a)(9)(D).

and all debts of the debtor that arose before the date of confirmation are discharged provided that the debtor continues to engage in business and is not liquidated under the plan of reorganization.⁴¹

The plan of reorganization will become effective no earlier than 11 days after the entry by the court of the confirmation order. Parties in interest have 10 days after the entry of the confirmation order to appeal the confirmation order; however, in practice, appeals of a confirmation order are often deemed moot once a plan of reorganization becomes effective and distributions are made. In order to avoid the appeal being deemed moot, a stay of the confirmation order pending appeal is required; however, the standard for obtaining the stay is difficult to satisfy. Assuming that the regulatory approvals have been obtained and a final order confirming the plan of reorganization has been entered, on the effective date, all distributions may be made under the plan of reorganization and all debts that arose prior to confirmation of the plan of reorganization are discharged with certain exceptions discussed below.

With respect to discharge, the Bankruptcy Code contains a special provision establishing a procedure for dealing in a Chapter 11 proceeding with future personal injury claims against the debtor based on exposure to asbestos containing products. The procedure involves the establishment of a trust to pay future claims coupled with an injunction to prevent future claimants from suing the debtor.

The Reform Act amends Section 1141 to limit the scope of the discharge accorded to corporate debtors. As amended, the statute provides that a corporate debtor will not be discharged from liabilities for a tax or customs duty with respect to which the debtor (i) made a fraudulent retention or (ii) willfully attempted in any way to evade or defeat such tax or customs duty.⁴²

5. Modifications of the Plan of Reorganization.

A plan of reorganization may be modified in accordance with Section 1127 of the Bankruptcy Code. A plan proponent can modify the plan of reorganization at any time prior to confirmation; however, after confirmation, a plan proponent can only modify the plan of reorganization if the plan of reorganization has not yet been substantially consummated. Material modifications to the plan of reorganization will require that the debtor re-solicit votes on the revised plan of reorganization.

The Reform Act added a new subsection (f), which provides that any modification of a plan of reorganization must comply with the requirements of Sections 1121-1129. The modified plan of reorganization becomes the plan of reorganization only if there has been adequate disclosure under Section 1125 as the bankruptcy court directs, notice and a hearing and the modification is approved.

E. Pre-Packaged and Pre-Negotiated Bankruptcies under Chapter 11.

A traditional Chapter 11 bankruptcy can be time consuming and impose a significant drain on a debtor's already limited resources. In contrast, a "pre-packaged" Chapter 11 has the benefit of avoiding a substantial portion of the costs and delays typically associated with a Chapter 11 proceeding. The key feature of a pre-packaged Chapter 11 is that the plan of reorganization is negotiated and voted on prior to the filing of a bankruptcy petition. A variation of a pre-packaged Chapter 11 is a "pre-negotiated" Chapter 11 case, in which the negotiation of the terms of the plan of reorganization is concluded prior to the filing of the Chapter 11 petition, but voting on the plan of reorganization does not occur until the post-petition period.

In both pre-packaged and pre-negotiated Chapter 11 cases, the debtor negotiates the terms of its restructuring with each of its key creditor constituencies, other than trade, prior to filing the petition. Trade and general creditors usually are not affected by the bankruptcy and continue to be paid, provided they continue to provide trade credit on normal business terms. Furthermore, in order to reduce the costs associated with litigation, many pre-packaged

⁴¹ 11 U.S.C. § 1141(d).

⁴² 11 U.S.C. § 1141(d)(6) (as amended).

bankruptcies do not involve the rejection of unexpired real property leases or executory contracts.

A pre-packaged plan of reorganization may be coupled with an out-of-court exchange offer, such that if a sufficient amount of debt is tendered into the exchange offer, the company would not file a Chapter 11 petition. In such situations, once the terms of the restructuring have been worked out, the debtor often will commence an out-of-court exchange offer containing the final terms of the restructuring for its outstanding publicly held debt securities, and enter into a restructuring agreement with its bank group providing a mechanism for the exchange of their debt. In conjunction with the exchange offer, which solicits tenders for the exchange of its outstanding debt securities, the debtor also solicits votes on its bankruptcy plan of reorganization. The exchange offer generally contains a high number of required tenders, because outside of Chapter 11, non-tendering bondholders are not bound by the exchange and continue to have all of their legal rights under the existing bonds. If that number is not obtained during the offer period, but the debtor is nonetheless able to obtain the sufficient number of votes for a confirmation of the plan of reorganization, the debtor will file a petition and include its plan of reorganization. The bankruptcy court then confirms the plan of reorganization according to the statutory criteria discussed above, making the plan of reorganization binding on each member of each class of interests.

Absent a statutory exemption, the materials for solicitation of votes on a pre-packaged plan of reorganization and exchange offer would require the prior approval of the SEC. For a pre-negotiated plan of reorganization (or a plan of reorganization in a traditional Chapter 11 case), the bankruptcy court approves the disclosure materials shortly after the case is commenced. Under current law, if a debtor commences solicitation of acceptances of a pre-negotiated plan of reorganization but a bankruptcy petition is filed before the end of the solicitation period, absent a court order approving the disclosure statement, the solicitation must stop. Accordingly, the process leading to the filing of a pre-packaged plan of reorganization is longer than that of a pre-negotiated

plan, though the length and costs of the actual bankruptcy case typically are less than for a pre-negotiated Chapter 11. In either case, the process is significantly more efficient, and the outcome more certain, than a traditional Chapter 11 case.

The Reform Act provides that the bankruptcy court may waive the requirement for the Bankruptcy Code's Section 341(a) mandatory meeting of creditors and equity holders where the debtor has solicited votes on a Chapter 11 plan of reorganization before the petition was filed.⁴³

The Reform Act clarifies that the acceptance or rejection of a plan of reorganization may be solicited before the debtor files for bankruptcy without providing a court approved disclosure statement and a copy of the plan of reorganization or a summary thereof as long as the solicitation complies with the relevant nonbankruptcy law.⁴⁴

II. Impact of Select Provisions of the Reform Act on Chapter 11 Cases.

A. Pre-Bankruptcy Planning.

1. Negotiating Debtor-in-Possession Financing.

The Reform Act will increase the liquidity needs of Chapter 11 debtors with a number of new expenses that will require appropriate budgeting. Adequate assurance for utilities will now need to be funded with cash, letters of credit, certificates of deposit or surety bonds. The enhancement of trade vendors' reclamation rights may require sufficient cash to pay off such claims. Cure payments for nonresidential leases being assumed will need to be paid no later than 210 days following the petition date. Debtors will no longer be permitted to allow businesses operated in spaces subject to nonresidential leases to "go dark" if they wish to assume and assign such leases; additional cash will be needed to

⁴³ 11 U.S.C. § 341(e) (as amended).

⁴⁴ 11 U.S.C. § 1125(g) (as amended).

maintain operations. This increase in liquidity requirements may be offset to a certain extent by the Amendments' limits on key employee retention and severance payments.

The effects of the Reform Act on a debtor's liquidity needs will take a while to ascertain fully. It remains unclear, for example, whether a trade vendor with reclamation rights will be entitled to immediate payment, or whether the current practice of granting such claims an administrative priority will remain in effect. Until the law becomes established in each jurisdiction, however, prudent bankruptcy planning for companies that have significant trade obligations, such as retailers and manufacturers, will require the negotiation of a financing facility sufficient to make such payments if available cash flow will not suffice.

2. Key Employee Retention.

The restrictions on key employee retention and severance payments to a debtor's insiders (e.g., officers and directors) will make it imperative for appropriate steps to be taken in order to avoid the loss of senior managers and employees with substantial knowledge of the company's business. All payments to insiders within two years of the petition date must be scrutinized for possible attack as fraudulent conveyances.

Perhaps more than any other provisions in the Reform Act, these limitations may effect significant changes in the nature of Chapter 11 practice. The Reform Act expressly seeks to curtail efforts at circumventing these restrictions such as entering into new pre-petition employment agreements; for example, a trustee's powers to avoid transfers to insiders outside of the ordinary course of business are enhanced. Over time, the provisions regarding retention and severance payments will very likely lead to a significant increase in pre-packaged or pre-negotiated Chapter 11 cases, so that such payments may be made as part of a confirmed plan of reorganization. It will also be likely that company insiders will seek to engage in sales of the business under Section 363, with new employment agreements being tied to the asset

purchase agreement, rather than face the risk of an extended Chapter 11 case.

3. Retention of Professionals; Change in Definition of "Disinterested Person."

The elimination of the per se disqualification of investment bankers for any outstanding security of the debtor (or in connection with the offer or issuance of any security of the debtor within three years prior to filing) means that investment banks with large underwriting practices will have opportunities to represent debtors that were previously foreclosed. A "disinterested person" still cannot be a creditor, shareholder or insider and cannot have "an interest materially adverse to the estate, or a class of creditors or equity security holders."

An investment bank for debtor in connection with the issuance of any of the debtor's securities may still face an uphill battle to be retained. If there is any litigation outstanding or threatened in connection with the issuance or sale of such securities, the investment bank may very well be deemed to hold "an interest materially adverse to the estate[.]" Such an investment bank could also be deemed to be a creditor by virtue of indemnity rights against the debtor. A full and complete analysis of potential objections to the retention of an investment bank during pre-bankruptcy planning will be vital, in order to avoid a battle over retention during the crucial early weeks of the Chapter 11 case.

4. Time Limits on Non-Residential Lease Assumption or Rejection.

It will be essential for a company, particularly a retailer with dozens, perhaps hundreds, of locations, to be able to have as clear a sense as possible as to which leases it will want to keep and which it will wish to reject before filing its case and starting the clock on the 210-day time frame.

Retailers often file in January or February, when their cash needs are lowest. The new time limit provisions, however, mean that a retailer debtor will not, absent landlord consent, have the benefit of measuring individual store performance during the following Christmas season before making a decision regarding lease assumption and

rejection for particular store sites. However, a retailer that files later in the year in order to be able to factor Christmas season results into its decisions will probably have much greater immediate cash needs and could risk disruptions precisely as it is planning its autumn and holiday business strategies.

5. Expansion of Reclamation Rights; Priority for Claims for Delivered Goods.

A company planning for Chapter 11 that incurs significant trade obligations in the ordinary course will need to engage in careful discussions with its important suppliers, so that it is not overwhelmed by reclamation demands in the early stages of its case.

These provisions, together with provisions that expand the availability of the ordinary course defense to preference actions, may ultimately redound to the benefit of distressed businesses. Currently, companies that are sliding into trouble are often forced to seek Chapter 11 relief when their key suppliers refuse to ship to them on credit. Particularly if the Reform Act forces companies contemplating Chapter 11 to engage in longer and more prolonged pre-bankruptcy planning, the Reform Act's enhancements of trade vendors' reclamation rights, priority for delivered goods within 20 days of the petition date, and preference defenses may make it easier for a distressed company to continue to obtain goods on credit, and thus improve its chances of arriving at a pre-packaged or pre-negotiated plan of reorganization.

B. Chapter 11 Practice and Procedure – First Day Motions and Orders.

1. Adequate Assurance to Utilities.

The Reform Act expressly defines “assurance of payment,” but also provides that such “assurance of payment” must be “satisfactory to the utility.”

A first day order establishing that a debtor has provided “adequate assurance of payment” may be insufficient to protect a debtor from a utility's alteration, refusal, or discontinuation of service, since the new statutory

language arguably gives a utility unfettered discretion to determine whether the form of assurance is “satisfactory.” Such orders should either be in the form of a “so-ordered” stipulation between the debtor and the utility, or else provide an express notice period within which the utility must inform the debtor if it finds the form of payment assurance “unsatisfactory.”

2. Reclamation Claims, Critical Vendor Payments.

A vendor seeking to establish a right of reclamation, in addition to providing time notice of demand, must still establish that the debtor was insolvent at the time of delivery. It is unclear whether other elements of a state or common law reclamation claim must still be established, and it is unclear whether courts may continue to provide an administrative priority claim in lieu of permitting the exercise of reclamation rights.

Until the law becomes settled, Chapter 11 debtors may continue to seek to resolve reclamation claims through the granting of an administrative priority claim, particularly if there is a good faith argument to be made regarding solvency. However, a desire to maintain strong vendor relationships may militate in the other direction, and lead a debtor to seek a first day order permitting the payment of pre-petition “critical vendor” claims. In any event, as stated above, it will be vital in pre-bankruptcy planning to ensure that there will be sufficient liquidity to pay reclamation claims.

C. Chapter 11 Practice and Procedure – Other Issues.

1. Creditor Access to Committee Information.

The Reform Act is silent on what it means for an official committee to provide “access to information.”

It is unlikely that courts will interpret this language to mandate the distribution of sensitive or otherwise confidential information that official committees, bound by their fiduciary obligations and sometimes express agreements of confidentiality, typically receive during the course of a Chapter 11 case. Debtors and official

committees should negotiate and seek approval of “information sharing” orders to establish appropriate protocols for compliance with this new requirement.

2. Non-residential Lease Assumption or Rejection.

Extensions of a debtor’s time to assume or reject past the 210-day deadline may only be granted with the landlord’s consent. Monetary obligations under a lease assumed and subsequently rejected will be entitled to an administrative expense priority, subject to a two-year cap. A debtor with valuable leases that it may wish to assume and assign will not be able to save money by allowing such business sites to “go dark.”

While these provisions generally favor landlords and place an onerous burden on debtors, they may in some cases cut the other way, and put a landlord in the position of being forced to “eat dirt” if it does not agree to extend the debtor’s time to assume or reject. It may be that over time it will become a not uncommon practice for debtors and landlords to agree to an extension, perhaps in exchange for some “kicker” payment above the debtor’s ongoing lease payments.

3. Consumer Protection.

The Reform Act provides that if a debtor maintains a policy of not transferring personal customer information to non-affiliates, then such information cannot be sold or leased under Section 363 unless the sale or lease is consistent with such policy, or the court approves, following the appointment of a “consumer privacy ombudsman,” upon due consideration of the facts and conditions of such sale or lease, and a showing that applicable non-bankruptcy law would not be violated.

This provision could have an impact on proposed Section 363 sales where assets such as customer lists have significant value. While it is likely that over time the courts will develop protocols for dealing with such sales, in the near term sales of such information will need to be carefully considered in order to avoid problems.

D. Plan Confirmation.

1. Limits on Extensions of Plan Exclusivity.

The new limits of 18 and 20 months for plan filing and the solicitation of acceptances, respectively, seek to shorten Chapter 11 cases by forcing debtors to engage in plan negotiations at an earlier stage in the proceedings.

While these provisions are clearly intended to bring Chapter 11 cases to speedier conclusions, they may in some cases produce an opposite result. The potential loss of exclusivity may lead to the filing and confirmation solicitation for “half baked” plans that have not been fully negotiated with major parties in interest and that could lead to more contested confirmation hearings. Moreover, if a debtor loses exclusivity and competing plans are filed, the resulting litigation could result in a longer and more expensive Chapter 11 case.

2. Treatment of Tax Claims.

Priority tax claims must now be paid in regular installments, over no longer than five years from the petition date, and on terms no less favorable than the most favored general unsecured claims.

These provisions may appear to be relatively innocuous, but they could hold a few pitfalls that could hinder plan confirmation. The requirement that tax claim payments be made in regular installments over a shorter time period could affect a company’s post-Chapter 11 liquidity and increase its exit financing requirements. This may be true particularly in pre-packaged or pre-negotiated Chapter 11 cases, in which trade creditors are often either left unimpaired or else paid in full on the plan effective date. It also raises questions as to how tax claims that are to be paid in cash should be treated in cases where other unsecured creditors receive equity in the reorganized company on the plan effective date.

3. Increase in Administrative Expenses.

Trade vendors will have an administrative priority claim for the “value” of goods delivered in the ordinary course of business within 20 days of the petition date. To the

extent that they are not paid at the beginning of the Chapter 11 case, there will be more reclamation claims entitled to administrative priority treatment due to the expansion of reclamation rights. Landlord claims for non-residential property leases that are assumed and then subsequently rejected will have administrative priority status (subject to a 2 year cap).

Absent creditor consent, administrative priority claims must be paid in full in cash on the effective date of the plan. As such claims proliferate, plan confirmation becomes

more difficult, and the debtor's cash needs upon exiting Chapter 11 become greater. Together with the effects of some of the other Amendments discussed above, particularly the limitations on retention and severance payments, there could be an increase in so-called Chapter 18 cases, in which a sale of a debtor's business is quickly effectuated, and then the case converted to a Chapter 7 liquidation for the distribution of proceeds remaining following the payment of secured claims.

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This memorandum is intended only as a general discussion of these issues. It should not be regarded as legal advice. We would be pleased to provide additional details or advice about specific situations if desired.

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