WORK-OUTS AND CHAPTER 11 OF THE US BANKRUPTCY CODE

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It is a pleasure and an honour to be here and speak before you on bankruptcy and insolvency matters.

Historically the United States bankruptcy law has had a strong orientation towards salvaging and reorganising distressed businesses. Railroad reorganisations in the 20's and the 30's reflected this viewpoint as did the early versions of the *Bankruptcy Code* which provided for reorganisations and arrangements with creditors for business enterprises.

In 1978 the United States *Bankruptcy Code* was extensively revised and the present provisions of Chapter 11 which provide for the reorganisation under court supervision of business debtors came into effect. Chapter 11's dual purposes are rehabilitation of the debtor's business and equitable treatment of creditors and stockholders.

The emphasis, however, is strongly upon rehabilitation. Bankruptcy courts, particularly in proceedings involving large public companies such as Eastern Airlines, Johns Manville or LTV have not been reluctant to exercise their equitable powers to assure continued operations of the business, often at the expense of creditors and stockholders.

To give you a brief outline of Chapter 11 before we have tea will be impossible, but I will attempt to give you some of the more important factors involved in Chapter 11.

In general any person, which is defined to include an individual, a partnership or a corporation, may be a debtor under Chapter 11 if it has a nexus in the United States other than a financial institution. A sufficient nexus with the US will exist for these purposes if the person has a domicile, a place of business, or property in the United States, and it can include a foreign corporation.

A case under Chapter 11 is commenced by the filing of a petition with the Bankruptcy Court. If it is filed by the debtor, it is called a voluntary case. A voluntary petition need only allege facts showing that the debtor is qualified to be a debtor under chapter 11 and the petition is deemed to be granted upon its filing. It is not necessary that the debtor be in financial difficulty. Indeed Texaco filed its Chapter 11 case in order to dispose of its US$11 billion judgment from Penzoil, although its balance sheet showed a substantial net worth and it clearly had no problem in paying its creditors.

A case may also be commenced by creditors, in which case it is called an involuntary case. A petition in an involuntary case must allege not only that the debtor is qualified under Chapter 11, but also that either the debtor is generally not paying its debts as they become due or that a custodian has been appointed for all or substantially all of its property.

Any holder of a claim against or an interest in a debtor is entitled to participate in the Chapter 11 case and has certain rights with respect to the plan of reorganisation. However, confirmation of a plan normally extinguishes all claims and interests arising up to the time of confirmation.

A claim includes any right to payment, whether liquidated, unliquidated, contingent, matured or unmatured. The filing of a Chapter 11 petition has the effect of automatically accelerating all debt. A claim also includes an equitable remedy for breach of performance. An interest is not defined, but generally includes a partnership interest or a stockholder or equity interest.

The plan of reorganisation must prescribe for distributions of cash and securities to some or all of the creditors and the holders of interest. Securities such as debt instruments or stock typically are the most important elements of these distributions reflecting the purpose of Chapter 11 to preserve the debtor's business and make its going concern value available to satisfy creditors. Often a plan will result in a substantial change in ownership, for example when an existing debt is exchanged for equity.

Upon entry of an order of the court confirming a plan, the debtor is authorised and required to make the distributions prescribed and all claims against the debtor that arose prior to the entry of the confirmation order are discharged except as specifically provided by the plan.

The debtor has the exclusive right for 120 days after the filing of the petition to propose a plan in the first instance. If this period of 120 days expires, any interested party may propose a plan. It is not unusual, however, in large complicated cases, for the debtor to seek and receive several extensions of the exclusivity period and the court usually grants these as long as progress in negotiating a plan is being made.

Once a plan has been proposed, the proponent solicits votes from creditors and holders of interest by distributing ballots and a disclosure statement. The disclosure statement performs a role analogous to that of a proxy statement for soliciting votes and a prospectus for the issuance of securities.

Voting on the plan is conducted by classes. Broadly, a class of claims or interests is deemed to have accepted the plan if it is accepted by the holders of two-thirds of the claims or interests. Following the vote the Bankruptcy Court confirms the plan if the plan satisfies various statutory criteria. In certain cases the court may confirm a plan that has not been accepted by one or more of the classes of creditors. This is commonly referred to as the "cram down". The court will not cram down a plan however, unless it is asked to do so by the plan's proponent, usually the debtor, and again certain statutory criteria must be satisfied basically designed to assure that the class of creditors against whom the cram down operates have been adequately protected.

Chapter 11 contemplates that the debtor normally remains in possession of its property as a "debtor in possession". In the case of a corporation this means that the management of the company remains in control. However, the Bankruptcy Court is empowered to appoint a trustee to take possession of the estate either for cause, including fraud, dishonesty, incompetence or a gross mismanagement, or if such appointment is deemed to be in the best interests of the creditors and the interest holders. Bankruptcy Courts strongly favour permitting the company to continue with its management and board of directors in place.

The unions tried unsuccessfully for over a year to oust the Eastern Air Lines management, but the court refused to appoint a trustee. Only after the unsecured creditors' committee petitioned recently for a trustee on the grounds that Eastern's management had been unable to meet any of its financial projections, and was unlikely to do so, did the court finally appoint a trustee. In the *Eastern* case the decision to appoint a trustee was also influenced by the allegations of self-dealing and conflicts of interest with Eastern's parent company, Texas Air.

Shortly after the commencement of a Chapter 11 case, a creditors' committee consisting of representatives usually of the five largest creditors, is appointed by the court to oversee the debtor and the reorganisation process. The court may appoint additional committees including secured creditors' committees, and these committees, particularly the unsecured creditors' committee plays an active role in negotiating with the debtor a plan of reorganisation. If the debtor and the unsecured creditors cannot reach agreement on a plan of reorganisation there is usually a fundamental problem and the result is either converting the Chapter 11 case into a Chapter 7 case, which is a liquidation, or as happened in the *Eastern Airlines* case, the appointment of a trustee.

The commencement of a case under Chapter 11 results in an automatic stay, prohibiting any effort to enforce a claim that arose prior to the commencement of the case. A wilful violation of the automatic stay is punishable by actual and punitive damages and US courts generally have deemed any action taken in violation of the stay to be void. The estate that is protected by the automatic stay consists of all property of the debtor, wherever located, the statute says. By its terms it applies to prohibit actions against the estate even if taken outside the United States and affecting property outside the United States. However, the power of the US courts to punish violations of the stay depends on the violator having sufficient contacts with the US so as to subject it to US court's jurisdiction.

The *Bankruptcy Code* authorises the debtor to operate its business during the period that the case continues. This authorisation empowers the debtor to enter into transactions and to incur obligations in the ordinary course of business. Interestingly in the usual case the debtor in possession is more creditworthy than its pre-filing predecessor. And this is because the highest priority of claims under the Code applies to administrative expenses which are defined as the actual necessary costs and expenses of preserving the estate. This priority applies to any debt incurred by the debtor in possession acting within its authority including obligations incurred in the ordinary course of business. The debtor typically must secure new financing for the period while the case is pending. The moratorium on the payment of pre-petition claims alleviates somewhat the urgency of arranging new financing, but is not normally sufficient.

To facilitate so-called debtor in possession or DIP financing as we refer to it, the Code provides that the court may accord such financing a super priority, superior even to the administrative priority for other post-petition debts.

In a recent filing in the *Campeau* case, Chemical Bank and Citibank led a consortium of banks that advanced $700,000,000 of new money within days of the filing. And even more recently in the *Ames Department Store* case, Chemical provided $250,000,000 of DIP financing leading some to conclude that this is a new type of lending activity for which banks will be competing in the 90's. The American Banker wrote an article just a few days ago saying "borrowers in Chapter 11 look enticing".

The debtor in a Chapter 11 case has exactly the same powers as the trustee in an ordinary bankruptcy proceeding to avoid or modify transactions entered into before the case was commenced. The most important of these powers are those dealing with the avoidance of preferences, fraudulent conveyances, and the termination of executory contracts.

Preferences

The debtor is entitled to recover certain transfers of property that would otherwise result in a particular creditor recovering a large percentage of its claim than others. In general preferences are transfers made on account of an antecedent debt within 90 days of the bankruptcy petition at a time when the debtor was insolvent. The 90 day period is extended to one year for so-called "insiders", that is, directors, officers and major shareholders. Furthermore, there is a statutory presumption that the debtor was insolvent within the 90 day period prior to filing of the petition. Thus, any repayment of a loan within the 90 days prior to bankruptcy can usually be recovered by the debtor.

Fraudulent Conveyances

The debtor in possession may recover pre-petition transfers of property and avoid pre-petition obligations if the transfer or the incurring of the obligations constituted a fraudulent conveyance. A fraudulent conveyance will occur if the transfer of property or the incurrence of the obligation is made with actual intent to hinder or defraud creditors, but also if the transfer or obligation was incurred even with no fraudulent intent in a transaction in which the debtor received less than reasonably equivalent value in exchange for the debt, and, if the debtor at the time of the transfer was insolvent or was engaged in a business with unreasonably small capital or incurred or intended to incur debts beyond the debtor's ability to pay.

In every leveraged buyout transaction lenders must be concerned as to whether the debt might be avoided as a fraudulent conveyance, or perhaps more likely, that the collateral security might be subject to attack as a fraudulent conveyance. This concern arises out of a federal appellate court decision generally referred to as the *Glen Eagles* case which stands for the proposition that the payment of proceeds of a borrowing to shareholders, typical in LBL transactions, is not fair consideration to the debtor and therefore if the other parts of the fraudulent conveyance test are met, liens granted to secure such a borrowing can be avoided.

A very powerful tool of the debtor in a Chapter 11 case is the so-called "strong arm" provision of the Code. This section basically provides that the debtor may avoid a transfer of property or the incurrence of any pre-petition debt if such a transfer or debt could be avoided by a creditor who obtained a judicial lien on all property of the debtor at the time of the commencement of the case. The debtor is thus in the position of a hypothetical lien creditor and can attack pre-petition liens on this basis. The effect of this provision is to permit the debtor to nullify purchases or liens on property if the purchaser or creditor has failed to satisfy the perfection or recording requirement of applicable state law prior to the bankruptcy proceeding.

Executory Contracts

The *Bankruptcy Code* contains special rules for executory contracts or leases, that is contracts that are entered into before the case is commenced, but under which the obligations of both the bankrupt and the other party to the contract are unperformed. The debtor is given a choice of assuming or rejecting an executory contract.

If the debtor rejects the contract it is deemed to have breached the contract immediately prior to the commencement of the case. The other party to the contract is relegated to a pre-petition claim which is usually unsecured for an amount determined under the usual rules for contract damages.

If the debtor assumes the contract, then it adopts the contract as an obligation of the debtor in possession. If the debtor thereafter breaches the assumed contract, a counter-party's claim for breach is entitled to an administrative priority. If the debtor assumes the contract it must cure all defaults except those that relate to the insolvency or financial condition of the debtor.

It is important to note that the quite usual contractual provisions for termination of a contract upon insolvency or bankruptcy will not necessarily be recognised by a Bankruptcy Court if the contract is executory.

As a general principle, US law will respect the separate identity of corporate entities and not require that a parent company put all of its subsidiaries into a proceeding when the parent company files. It is not uncommon for substantial subsidiaries to continue in business during the pendency of the parent's Chapter 11 case. For example, the substantial refining and trading subsidiaries of Texaco continued in business during the reorganisation of the parent company and in the Drexel Burnham Lambea Group Inc's filing, their major broker/dealer subsidiary Drexel Burnham Lambea Inc has not been brought into the parent company's proceedings.

Under the doctrine of substantive consolidation however, a Bankruptcy Court may in certain circumstances treat a parent and a subsidiary as a single enterprise so that all the assets and revenues of the combined enterprise are available to satisfy the claims of the creditors of the parent and subsidiary alike.

Substantive consolidation is, however, an exception to the usual rule limiting a stockholder's liability for the obligations of the corporation and the courts are hesitant to order a substantive consolidation unless all affected groups consent. The three overriding principles supporting substantive consolidation are:

(i) the practical difficulty in distinguishing the assets and liabilities of the two enterprises;

(ii) a pre-petition pattern of operations indicating that the parent and the subsidiaries were operated essentially as one enterprise; and

(iii) circumstances that would make it unfair not to permit the creditors of one company to obtain satisfaction of their claims from the other.

Often there is a temptation in dealing with distressed business enterprises in the United States to believe that Chapter 11 is a relatively quick and painless way out of a distressed business enterprise. One is tempted to this conclusion because Chapter 11 provides an automatic stay of creditors, there is the possibility of settling or eliminating contingent or potential future claims, and the enterprise can get interim financing to deal with its liquidity crisis and perhaps emerge from bankruptcy in six to nine months. While there are some situations where this reasoning holds true, generally it does not.

First, almost every case lasts longer and is more expensive than was originally anticipated. Even the *Texaco* case which was a relative success in that it resulted in a settlement of the Penzoil claim and Texaco emerged solvent and clearly a profitable enterprise, that proceeding lasted twelve months and the fees and expenses in the proceeding exceeded $50,000,000. When Eastern Air Lines filed its bankruptcy petition in March of 1989, the company confidently predicted a six month proceedings. We are now in May of 1990, a trustee has been appointed, and there seems to be no end immediately in sight.

Secondly, it is often very difficult to deal with unliquidated claims. Johns Manville tried to use the Chapter 11 process, mistakenly in my view, to obtain a discharge of the billions of dollars of asbestos liability suits which had been filed and which were predicted to be filed in the future. This was a unique and unprecedented situation. The Bankruptcy Court was asked to set up a settlement fund which would be binding upon all future claimants. In fact the company ended up with a settlement fund which resulted in an enormous drain on its earnings and the settlement of claims has resulted in a much faster depletion of the fund than originally contemplated.

And finally I would note that the entire Chapter 11 process, something that often managements in dealing with the possibility of filing a Chapter 11 case overlook, the entire process requires extraordinary dedication of management time and energies which means that the business itself is often neglected and this is simply because the entire process requires attention to the court proceedings where practically every significant action of the debtor in the course of the proceedings is scrutinised and often has to be approved in advance by the court.