



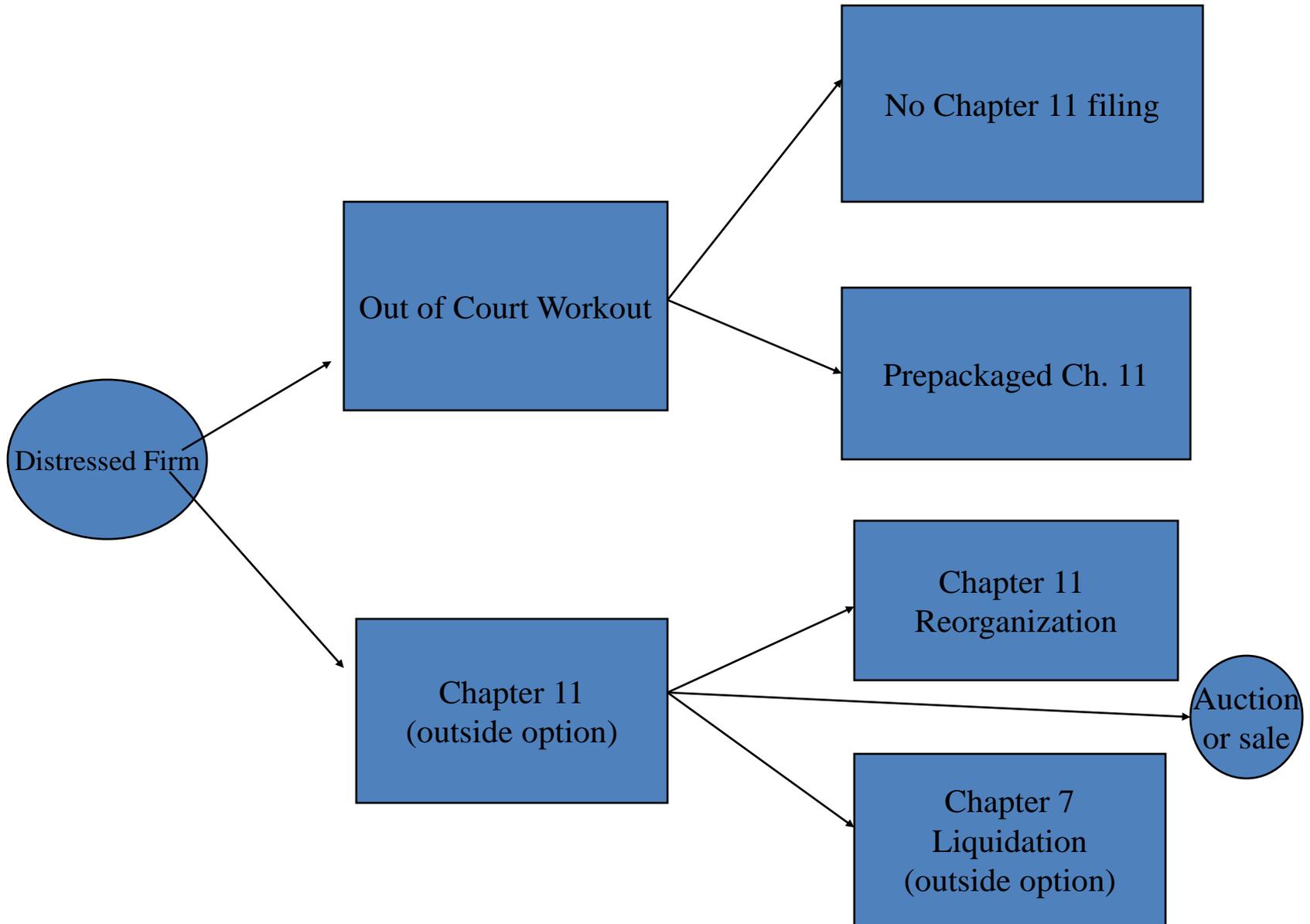
# Corporate Workouts, Bankruptcy & Restructuring – NYU School of Continuing and Professional Studies

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# Chapter 11 Not First Choice

- Almost all large, publicly traded firms attempt to workout debt before entering Chapter 11
- Why do firms attempt a workout?
- Costs
  - Direct Costs -- Professional Fees
  - Indirect Costs
    - Management Distractions
    - Stigma



# Who is eligible for bankruptcy?

- Each Chapter has eligibility requirements
- Chapter 7 and 11
  - Available for individuals and many corporations
  - Insurance companies and banks are not eligible
  - Railroads can file an 11
  - Stockbrokers can file a 7
- Chapter 13
  - Individuals with no more than \$307,675 unsecured debt or \$922,675 secured

# Types of Bankruptcy Cases

- 2 Varieties
  - Liquidation
  - Reorganization
- Voluntary
  - Most cases are commenced by the debtor
- Involuntary
  - Creditors may force a debtor into bankruptcy

# Chapter 7 Cases

- Liquidation
- “Straight bankruptcy”
- Individual and companies are eligible
- Trustee appointed
  - Entrusted with debtor’s assets
  - Liquidate assets
  - Distributes cash to creditors
- Individual debtor will receive a discharge

# Chapter 11

- Business reorganization
- Can take the form of a liquidation
- May be used by individuals to restructure

# Other Bankruptcy Cases

- Chapter 9
  - Municipal Bankruptcies
- Chapter 12
  - Family farm and some fisherman reorganization
- Chapter 15
  - Designed to assist foreign bankruptcy proceedings

# Chapter 11 Filing

- **Debtor's management stays in place**
- **Debtor becomes debtor in possession**
- **May operate in ordinary course of business**
- **Filing Chapter 11 creates point of cleavage**
- **Debtor cannot pay "claims" that arose prior to filing date**

# Where is a bankruptcy case filed?

- Bankruptcy court
  - Unit of the district court
- Generally, domicile, residence, principal place of business or principal assets in the U.S. for the 180 day period prior to filing.

# Upon Filing For Bankruptcy

- **2 things generally occur**
  - **Estate is created**
  - **Automatic Stay is imposed**
- **Bankruptcy cases are randomly assigned**
- **Office of the US trustee monitors all cases**
  - **Arm of the DOJ**
  - **Not to be confused with a chapter 7 or 13 “trustee”**

# Property of Estate

- Broad definition
- All legal or equitable interests of the debtor in property as of the commencement of the case.
  - Wherever located and by whomever held
- Property of the estate will generally be distributed to creditors.

# Automatic Stay

- **Stay arises automatically upon filing**
- **Enjoins claim collection or enforcement of pre-filing rights**
- **Contract party may not terminate a contract simply because the debtor filed for chapter 11 relief or became insolvent**
- **Violation of the automatic stay by a creditor may subject the violator to sanctions**
- **Applies to unsecured and secured creditors**

# Other Limits to Automatic Stay

- **Does NOT apply to actions against third parties or property of third parties**
  - E.g., Letter of Credit – promise by third party (usually bank) to pay if debtor does not
  - Generally, beneficiary of letter of credit can draw on the l/c and not a violation of A/stay.
- **Creditors can pursue guarantors**
- **Creditors may also seek relief from the automatic stay**
- **If granting relief to creditor will not harm debtor**
  - E.G., courts generally grant relief to allow tort suits (i.e., personal injury claims) to go forward in state court where claimants agrees that any judgment will be collected only from insurance
- **Secured creditor (with a lien on property) may also obtain relief from automatic stay if:**
  - Debtor doesn't have equity in the property, and
  - property is not necessary to an effective reorganization
- **Equity – difference between value of property and liens against it (e.g., computer equipment financed by debtor is worth \$1mm and liens against it are \$1.5mm – Debtor has no equity in property)**
  - Debtor must show that property is necessary to a successful reorganization within a reasonable time

# How does filing Chapter 11 disrupt business?

- **Trade creditors may stop providing goods/services on credit**
- **Vendors/employees may become uncooperative**
- **Customers may cease doing business**

# Responsibility of DIP

- Fiduciary to creditors and equity
- Must continue to honor contracts
  - Non-debtor parties are not excused
  - Major exception: credit agreements
- Reporting requirements
- Negotiate a reorganization/liquidation plan

# “First Day” Relief

- **First Day Motions/Order designed to obtain relief from Court to alleviate concerns of creditors, customers, employees**
- **Designed to -- avoid disruption in conduct of debtor’s business and preserve Going Concern Value**
- **Also a way for Debtor to give the Bankruptcy Judge a first impression of its case and the legal issues to be addressed**

# **Examples of First Day Relief**

- Retention of Professionals for estate (Court cannot approve retention during initial 20 days of case)**
- Authorize payment of pre-petition date employee claims**
- Pay claims of critical vendors**
- Authorize to continue pre-bankruptcy customer programs, e.g.,**
  - Honor airline miles or frequent flyer programs**
  - Honor warranties**

# First Day Relief Requirements

- Doctrine of Necessity -- payment of pre-petition claims under “First Day” Motion requires Bankruptcy courts to make finding that immediate payment of prepetition claims is essential to debtor’s survival
- *See In re Ionosphere Clubs, Inc.*, 98 B.R. 174 (Bankr. S.D.N.Y. 1989) (holding that doctrine of necessity allowed payment of active workers’ prepetition claims for wages)

## Appointment of Committee(s)

- **UST may appoint committee(s) of unsecured creditors**
  - **Multiple committees are possible, but rare**
  - **May also appoint committee of equityholders**
- **May retain counsel and other professionals**
- **The unsecured creditors' committee is a fiduciary for all other unsecured creditors**
- **Major player in a chapter 11 case.**

# Appointment of Committee(s) (cont'd)

- **Primary functions are:**
  - negotiate plan of reorganization with debtor;
  - monitor debtor's operations;
  - investigate activities of debtor (including, potential preferences and fraudulent transfers); and
  - communicate with unsecured creditors.
- **Unsecured creditors' committee may retain professionals including, lawyers, accountants and financial advisors**
  - These professionals are paid by debtor's estate
  - debtor must cooperate with creditors' committee and its professionals

# Chapter 11 Trustee

- **Generally, when debtor files ch. 11, management stays in place**
- **There are circumstances when Bankruptcy Court can appoint trustee or examiner.**
  - **Fraud**
  - **Dishonesty**
  - **Mismanagement**
  - **Incompetence or**
  - **Appointment is in “best interests of creditors, any equity security holders, and other interests of the estate.”**
- **The Bankruptcy Court determines whether a trustee should be appointed**
- **The U.S. Trustee’s Office appoints the trustee**
- **The trustee is responsible for operating debtor’s business and formulating plan**

# Examiner

- Bankruptcy Code also provides for appointment of examiner
- Can appoint examiner only if a trustee is not appointed
- Not difficult to get an examiner appointed – generally, if non-trade debt exceeds \$5mm
- Examiner's role is more limited than trustee – does not run debtor's business
- Examiner is appointed to investigate certain aspects of debtor's business and submit a report to Bankruptcy Court

# Claims – General

## Chapter 11 Priorities

- In typical bankruptcy case, claimants of the firm will be paid according to absolute priority
  - First - Secured Claimants
  - Administrative claims
    - Includes suppliers of goods/services received by debtor within 20 days prior to filing
  - Bankr. Code Priority Scheme
    - Employee claims
    - Customer claims
    - Tax claims
  - Unsecured creditors, then equity

# What is a Claim?

- Bankruptcy is designed to address claims against debtor.
- A Claim is defined as:
  - right to payment, whether or not such right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured, or unsecured; or
  - right to an equitable remedy for breach of performance if such breach gives rise to a right to payment, whether or not such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured, or unsecured.
- Definition is intended to be broad.
- When analyzing whether a client has a claim against a debtor, defer to the conclusion that it does.

# Examples of Claims

- Invoice for goods or services
- Credit card bills
- Breach of contract claims
- Personal injury claims
  
- Generally speaking, bankruptcy is designed to deal with pre-petition claims.
  - Post-petition claims are generally entitled to be paid in full and not in so called “bankruptcy dollars.”
  
- The value of Claim may be unknown.
  - Claim may be contingent or unliquidated.

# Types of Claims

- The ability of a Claim holder to recover in a bankruptcy case will depend on the type and the priority of the claim in held.
- In general, a Claim may be
  - Secured
  - Unsecured
  - Priority
  - Administrative

# Secured/Unsecured Claims

- A secured claim is a Claim that is supported by an interest in property.
- A secured claim is a Claim that is encumbered by a lien in property.
- A lien is “any charge against or interest in property to secure payment of a debt or performance of an obligation.”
- A Claim that is not encumbered by a lien in property is unsecured.
- A secured creditor will generally be entitled to the proceeds of its collateral while other creditors will be paid in accordance with their priority.

# Examples of Secured Claims

- Mortgage
- Car loan
- Mechanic's lien
  
- Secured creditors are entitled to a number of special rights and protections.
  
- In particular, a secured creditor is generally entitled to be paid from the proceeds of its collateral before other creditors are paid.
  
- Thus, a bank holding a mortgage will get the proceeds of a sale of the mortgaged property before those proceeds may be used to pay other claims.

# Bifurcation of Claims

- Section 506(a) of the Bankruptcy Code provides that a Claim that is secured by a lien on property “is a secured claim to the extent of the value of such creditor’s interest in the estate’s interest in such property ... and is an unsecured claim to the extent that the value of such creditor’s interest [in such property] is less than” the Claim.
- Depending on the value of the collateral, a creditor may have a secured claim and an unsecured claim.

# Fully Secured

- If the value of the Claim is equal to value of the collateral, the creditor is fully secured.

# Undersecured Claim

- If the value of the collateral is less than the Claim, the creditor is undersecured and has a secured and unsecured Claim.
- \$1 million Claim
- Collateral is valued at \$750k
- Creditor has a secured claim of \$750k and an unsecured deficiency claim of \$250k
- In a Chapter 11 case, as an undersecured creditor may elect to have its entire claim treated as secured.
  - If this election is made, must be made before approval of the disclosure statement and the creditor must receive payments that total the amount of its claim, but have a present value equal to the value of the collateral.

# Oversecured Claim

- If the value of the collateral is greater than the Claim, the creditor is oversecured and has only a secured Claim.
- \$1 million Claim
- Collateral is valued at \$2 million
- Creditor has a secured claim of \$1 million.
- The “other” \$1 million is available for other Claims.
- Oversecured creditors are entitled to post-petition interest and reasonable fees, costs and expenses provided under an agreement or statute.

# Valuation of Collateral

- In applying section 506, courts must first determine the interest to be valued.
- Once that is determined, they must then value the interest.
- Property may be valued in different amounts at different points of a case.
- In general, courts will determine the “fair market value.”

# Valuation of Collateral (cont'd)

- Valuation is a flexible concept.
- Collateral should be valued “in light of the purposed of the valuation and of the proposed disposition or use of such property.”
  - Collateral that is being sold may therefore be valued differently than collateral being retained by a debtor.

# Priority Claims

- Congress has determined that certain unsecured Claims should be paid prior to others.
- Section 507 of the Bankruptcy Code sets forth the order of priority.
- All priority claims must be paid in full before other unsecured creditors are paid.
- Moreover, higher priority claims must be paid in full before lower priority claims are paid.
- Courts are bound by and cannot alter the priority scheme.
  - Creditors, however, may change the order of payment by agreement or through plan provisions. (Subordination/intercreditor agreements.)

# Priority Claims Under 507:

- 1st Priority Claims – Domestic Support Obligations – don't apply to chapter 11 business reorgs
- 2<sup>nd</sup> Priority -- Admins – professional fees and other costs of maintaining debtor's property in a ch 11
  - **Will always have administrative priority claims in a chapter 11**
  - **Administrative claims in a chapter 11 case that is converted to a case under chapter 7 are subordinated to the administrative claims arising in the chapter 7 case**
- 3<sup>rd</sup> Priority – Ordinary Course of business claims incurred after involuntary petition filed – Involuntary GAP Period Claims
  - **If involuntary petition is filed, Debtor has time to contest the filing.**
  - **If Debtor does not contest filing or if Court determines that involuntary is proper, then an order for relief is entered**
  - **Order for Relief – indicates chapter 11 has commenced**
  - **Bankr. Code protects creditors who conduct business with Debtor after involuntary filed before Order for Relief is entered and gives those creditors 3<sup>rd</sup> priority**
- 4<sup>th</sup> Priority – claims of employees for wages, commissions, vacation pay, severance and sick leave - capped at \$11,725 per employee
- 5<sup>th</sup> Priority – claims for contributions to employee benefit plans –
- 8<sup>th</sup> Priority – certain pre-petition taxes, including w/holding taxes

# Subordination

## Contractual Subordination

- Bankr. Code section 510(a) expressly provides that a subordination agreement between claimants is enforceable
- Bankruptcy Ct. will therefore enforce subordination agreements between parties
- Usually find contractual subordination in inter-creditor agreements

## Equitable Subordination

- BC section 510(c) – allows Bankruptcy Ct to relegate (subordinate) a claim to lower priority level on basis of equitable principles
- Congress codified the doctrine of equitable subordination; it did not, however, provide specific criteria for courts to determine whether to demote claims to a lower payment level.
- Congress left it to Bankruptcy Courts to define parameters of equitable subordination
- Generally, Bankruptcy Court may equitably subordinate claim of creditor when creditor engages in inequitable conduct AND such conduct injured other creditors

## Equitable Subordination (cont'd)

- Equitable Subordination has been employed sparingly
- When creditor is not an insider, egregious conduct is required before the court will equitably subordinate its claim
- *E.G.*, Breach of Fiduciary Duty by Insider
  - *E.G.*, In re Citicorp Venture Capital, Ltd., 160 F.3d 982 (3d Cir. 1998), court equitably subordinated claim of an insider of debtor because it secretly purchased claims of creditors based on special information it obtained because of its insider status.
  - In this case, claims buyer did not disclose the information to the sellers of the claims

# **Funding a Chapter 11 Case:**

- **In chapter 11, Debtor continues to operate**
- **Needs cash to pay, among others:**
  - **Employees**
  - **Professionals**
  - **Suppliers**
  - **Utilities**
- **What are sources of cash to pay to operating expenses?**
  - **Cash Collateral**
  - **DIP Financing**

# CASH COLLATERAL

- WHAT IS IT?
  - CASH or CASH EQUIVALENT that creditor has security interest in
  - Usually in commercial loan transaction, security agreement gives
    - **PROPERTY THAT DEBTOR:**
      - CURRENTLY OWNS,
      - ACQUIRED LATER BY D and
      - PROCEEDS OF SUCH PROP
- *E.G.*,
  - Bank lends \$1MM to Debtor secured by
    - Debtor's inventory, now owned and acquired later
  - If Debtor files chapter 11, cash acquired upon sale of pre-petition inventory is bank's cash collateral.

## Bank's Security Interest

- **Bankruptcy code cuts off secured lender's after-acquired property clause**
- **Thus, inventory acquired post-bankruptcy is free of Bank's security interest**
- ***E.G.***
  - **October 1, bank lends debtor \$1 MM**
  - **Bank obtains security interest in all debtor's inventory then existing and later acquired**
  - **October 31, debtor acquires more inventory**
  - **November 1, debtor files chapter 11**
  - **November 15, debtor acquires additional inventory**

# **Which inventory does a bank have valid security interest in?**

- **Outside Bankruptcy-ALL**
- **In Bankruptcy (Section 552(a)), bank's lien extends only to:**
  - **October 1 inventory**
  - **October 31 inventory**
- **Section 552(a) limits reach of lien – does not extend to property acquired after commence EXCEPT**
  - **Section 552(b) – Permits pre-petition lien to extend to proceeds of pre-petition collateral**
- **Use previous example:**
  - **After bankruptcy, on November 10<sup>th</sup>, debtor pre-petition inventory**
  - **Proceeds from this sale subject to bank's security interest**
  - **Proceeds (usually cash) is considered cash collateral**

# Can a Debtor use this Cash Collateral?

- *DIP can generally use property in ordinary course*
- *This rule does not apply to cash collateral*
- **Bankruptcy Code says YES if:**
  - Bank consents OR
  - Court orders it after finding bank is adequately protected
- **Assume bank won't consent**
- **What type of adequate protection can Debtor offer bank?**
  - Bankruptcy Code gives flexible definition of adequate protection
    - *E.G.s.,*
      - CASH
      - EQUITY CUSHION
        - » VALUE OF COLLATERAL EXCEEDS LIENS
      - LIENS ON UNENCUMBERED ASSETS
- **Bankruptcy code cuts off security interests in property acquired after bankruptcy**
- **Thus, bank's lien does not extend to inventory acquired post-petition**
- **Debtor can offer bank a security interest in inventory acquired post-petition as adequate protection**

- **As practical matter, secured lenders generally agree to a debtor's use of cash collateral if:**
  - **Debtor provides replacement lien on post-petition property**
- **Cash collateral is typically debtor's initial source of funding**
- **Cash collateral alone, however, usually not sufficient**
- **Debtor will have to obtain additional financing**
- **Other type of financing - DIP financing**
- **Section 364 of Bankruptcy Code authorizes debtor to obtain post-petition financing**

# What if Cash Collateral is not Enough?

- Debtor may be able to obtain credit without court approval
  - Ex: extension of trade credit by vendors
  - Administrative expense
- Generally -- entity cannot be forced to do business with DIP even if DIP is willing to pay cash in advance or upon delivery
- Extension of unsecured credit to DIP within discretion of vendor
- However, administrative expense priority is not a guaranty of payment
- These claims are entitled to be paid with other administrative claims

# Court may authorize unsecured credit outside ordinary course

- Borrowings under 364(b) give lender administrative expense priority
- Bankruptcy Court must approve it first
- *E.G.*,
  - Debtor seeks to borrow \$1 MM to build new project
  - Bank willing to lend without obtaining SI in Debtor's property
  - If Bankruptcy Court is satisfied that loan would be beneficial to Debtor and in best interest, then approve it
  - Bank would get admin expense
  - Rare instances where Bank would agree to this

# Bankruptcy Court may authorize secured financing

- DIP may borrow money under 364(c) if authorized by Bankruptcy Court
- Some Courts require debtor to explore § 364(a) and (b) financing before approve 364(c)
- **Debtor argues that without financing, its reorganization will fail**
- Accordingly, debtor must give DIP lender concessions to obtain DIP Financing
- Bankruptcy Code authorizes DIP to offer 3 forms of security under 364(c)
  - Super-priority status – i.e., Priority over admin expense claims
    - DIP lender’s super-priority claim superior to admin expense claims, including professionals
  - Liens on property not previously encumbered
  - Junior liens on property previously encumbered
- *E.G.*,
  - Debtor files chapter 11
  - Pre-petition lender has security interest in all debtor’s inventory and a/recs.
  - Lenders’ security interest does not reach inventory and accounts acquired post-petition
  - Thus, such property is not previously encumbered
  - Debtor may offer DIP financing bank security interest in post-petition accounts/inventory as collateral for DIP financing

# Bankruptcy Court may “prime” existing secured creditors

- Lien on property already encumbered
- Such post-petition lien will have priority over pre-petition liens
- Primes pre-petition lien
- Debtor will request 364(d) financing if priorities provided by section 364(c) are insufficient to entice potential DIP lenders
- *E.G.*,
  - Pre-petition, bank makes \$1 mm loan to debtor to finance construct of building
  - Bank obtains mortgage on project
  - Debtor unable to complete project with \$1 mm and cannot obtain additional loan
  - Assume debtor files ch 11
  - Bank 2 is willing to loan debtor \$500k to complete project but only if it receives priority lien on project
  - Under 364(d), Bkcty Ct. can authorize debtor to give Bank 2 a lien with priority over Bank 1
  - But Bank 1 is second in line? Is this fair?

# Ability to Prime

- 364(d) imposes 3 requirements:
  - Financing must be on notice to Bank 1 with opportunity to be heard;
  - Debtor must provide evidence that it could not obtain other financing; and
  - Bank 1 is adequately protected
- WHAT TYPE OF ADEQUATE PROTECTION?
  - Is Bank 1 adequately protected by Equity Cushion?
  - Value of the collateral far exceeds liens
  - If Equity Cushion is available and is adequate, why does Bank 2 insist on priming lien?
- Generally, large equity cushion is required to permit a priming lien – usually in excess of 20%

# What is an executory contract (“K”)?

- Contract between D and another party -- which both sides still have important performance remaining
- Put another way, if either side stopped performing, it would be an actual breach of contract
- *EXAMPLES*
  - Real estate leases (tenant has to pay rent/landlord has to provide space)
  - Equipment leases (lessee has to pay rent/lessor has to provide equipment)
  - Development contracts (development work required/payment required on milestones),
  - Licenses to intellectual property (licensee can use only within scope of license/licensor must refrain from suing for licensed uses)
  - Utility service agreements

# IPSO FACTO CLAUSES

- Many Ks provide that if Debtor becomes insolvent or files bankruptcy, such K shall be terminated
- These clauses are called ipso facto clauses
- Bankruptcy Code (S 365(e)) invalidates such clauses
- Executory Ks remain in effect notwithstanding such provisions

# Why do executory Ks matter so much in chapter 11?

- DIP gets to decide whether to agree to perform or refuse to perform its obligations under executory contract
- Agreeing to perform translates to “assumption” of contract and
- Refusing to perform translates to “rejection”
- Cannot assume select beneficial portions and reject other portions
- During time debtor is considering whether to assume/reject:
  - non-debtor party to executory contract – has to keep performing as if no bankruptcy had been filed

# Assumption

- If DIP wants to assume
  - Exercise of reasonable business judgment
  - DIP must cure any monetary defaults
  - Nonmonetary:
- If DIP wants to assume and assign
  - DIP must cure; and
  - must provide adequate assurances of future performance
- Special considerations for shopping centers
- Several factors must be met under Bankruptcy Code – set forth in 365(b)(3)
- *E.G.*,
  - Financial condition of assignor must be similar to d at time d become t under lease

# REJECTION OF EXECUTORY Ks

- **GENERAL RULE – REJECTION OF K IS DEEMED A BREACH OF SUCH K AS OF THE PETITION DATE**
- Claim arising from rejected K is an unsecured claim
- When Debtor rejects K, other party cannot compel performance
- It can, however, assert claim for damages resulting from rejection (breach)
- Such damages paid only at same pro-rata level as payments made to general unsecured creditors
- How much time does debtor have to determine whether to assume or reject?
- Executory Ks -- other than non-residential real prop leases
  - Debtor has until confirmation of POR
  - Non debtor parties to contract may ask Bankruptcy Court to fix earlier date
  - Generally disfavored

# Leases for nonresidential real property

- Must be assumed/rejected within 120 days of petition date or such additional time as the bankruptcy court fixes, but not to exceed 210 days after the filing
- Prior to October 17 2005, chapter 11 debtors had to assume/reject non-residential real property leases within 60 days after filing
- 60 day period was routinely extended by Bankruptcy Courts upon showing of “cause” by Debtors
- Cause was easily shown by retail debtors
  - Cause found when:
    - » Many leases
    - » Need extra time to determine stores it will continue to operate – formulate bus plan
    - » At min, debtor must be current with post-pet rent
  - Many Bankruptcy Courts would extend time for most chapter 11 debtors – routinely
  - Granted unlimited extensions
  - Many times, extended to confirmation
  - Thus, some extensions would be well over many years
- During this time, store could remain dark while an assignee was found

# Leases for nonresidential real property (cont'd)

- Shopping center landlords argued that limbo of endless extensions of time to assume or reject leases were hurting centers
- Landlord lobby persuaded Congress to amend Bankruptcy Code so now time to assume/rejected nonresidential real property leases fixed at max of 210 days
- 2005 amendments – 120 day initial period during which debtor must assume/reject lease
- However, debtor may file motion prior to expiration of 120 day deadline for an extension of this period for 90 days for “cause”
- If court grants first 90-day extension, it cannot further extend the assumption/rejection period without prior written consent of lessor/landlord

# Non-Residential Real Prop Leases

- **Bankruptcy Code requires timely performance of all obligations (including payment of rent) arising after Petition Date under Nonresidential real property leases**
- **All post-petition, pre-reject rent is entitled to admin expense priority**
- **Lessor is entitled to payment regardless of whether debtor occupies premises**
- **Lessor's admin expense claim not based on benefit conferred on estate**
- **502(b)(6) cap is designed to limit damage claims of landlords**
- **Congress wanted to limit damage claims of landlord so other unsecured creditors could share in distributions**

# **"Anti-Assignment" Provisions in Non-Residential Real Property Leases:**

- **Many leases contain provisions that prohibit assignment of lease**
- **Prohibit store from going dark**
- **Limit use of premises**
  
- **Essential concerns for landlords:**
  - **Lengthy periods of non-operation (particularly with shopping centers),**
  - **Protection of landlord rights to control premises alteration (including subdividing),**
  - **Preserving landlord rights to object to identity (type or nature of business) and/or**
  - **Financial wherewithal of successor tenant who is proposed, and of future tenancies.**
  
- **Bankruptcy Courts frequently rule that none of provisions in lease (or local law) that restrict non-operation ("going dark"), use/tenant mix, premises alteration/subdividing, and future assignments and subletting, were enforceable**
  
- **Some Debtors obtained rulings "striking" provisions from the lease.**
  - ***E.G., Rickel Home Centers, 240 B.R. at 832 (in non-shopping center -- clause restricting premises use as home improvement store permanently stricken from lease to permit office supply store use)***
  
- **For shopping centers, assignment must comply with use provisions**

# Avoidance of Transfers

- **Certain transfers may be subject to avoidance and recovery**
- **What type of transfers?**
  - Payments of money
  - Gifts of debtor's prop
  - Grant of security interest in collateral
  - Grant of security interest in additional collateral
- **Potential source of significant recovery to estate**
- **Time limits on when estate representative can seek to avoid transfers?**
  - 2 years after filing

# Types of Avoidance Actions

- Preferences
  - Unique to the Bankruptcy Code
- Fraudulent Transfers
  - Available under federal and state law

# Preferences

- **Bankruptcy Code allows debtor's estate to recover certain preferential transfers of property made by debtor**
- **Rationale for recover of preferences?**
  - Discourage race to courthouse
  - Facilitate one Bankruptcy Code Policy – Equality of Distribution

# **ELEMENTS OF PREFERENCE:**

- **Transfer of property of Debtor**
- **To a creditor (or for creditor's benefit)**
- **Transfer made on account of antecedent debt**
  - i.e., debt owed to the creditor prior to the transfer
- **Debtor insolvent at time of transfer (presumption of insolvency)**
- **Transfer made:**
  - w/in 90 days before filing or
  - if transfer to insider, w/in 1 year
- **INSIDERS?**
  - Relatives of individual debtor
  - D&O of corporate debtor
  - Affiliates of corporate debtor
  - Party that controls corporate debtor
- **Transfer allows transferee to receive more than it would receive if debtor were to liquidate under chapter 7**
  - **This element satisfied unless:**
    - Transferee is fully secured creditor or
    - Unsecureds are paid in full
  - **Requires Court to compare what transferee received to what would receive in a chapter 7 liquidation**

## **Preferences (cont'd)**

- **Must be transfer of Debtor's property**
- **Property of Debtor is broadly defined by Bankruptcy Code – very expansive**
- **Supreme Court -- Begier v. Internal Revenue Service, Considered whether trustee/DIP could avoid or recover from IRS certain tax payments Debtor made before it filed**
- **Sup Ct held funds withheld by Debtor and paid by Debtor to IRS were not Debtor's property**
- **Instead, funds were held in trust by Debtor for IRS. Accordingly, Sup Ct concluded trustee/DIP could not recover funds**
- **Earmarked Funds – not Debtor's property**
- **Funds advanced to Debtor by third party expressly for purpose of paying Debtor's creditor**
- **Creditor can assert earmarking defense if sued by DIP or trustee**

# Defenses to Preferences

- **CONTEMPORANEOUS EXCHANGE OF NEW VALUE**
- **Transfer for contemporaneous exchange of new value given to debtor**
- *E.G.*
  - COD
- *E.G., 2*
  - Debtor borrows \$1mm from bank on Jan. 1
  - Both Debtor and bank intend for loan to be secured
  - Secured by lien on Debtor's receivables
  - On Jan. 5, bank perfects SI in receivables
  - On March 1, Debtor files
  - Can DIP/trustee avoid SI? **NO**
  - Transfer protected under contemporaneous exchange for new value exception
  - Transfer was substantially contemporaneous and parties intended that transfer be contemporaneous

# Defenses to Preferences

- **ORDINARY COURSE TRANSACTIONS**
- Generally, this defense allows defendants to protect payments that were ordinary as between parties
- Defense protects payments made to satisfy debts incurred in ordinary course of business of debtor and transferee
- Designed to protect normal transactions
- Look to history between parties to determine whether ordinary
- **Wolas decision**: Supreme Court ruled that payments on long-term debt could be considered ordinary course

# Defenses to Preferences

- **SUBSEQUENT NEW VALUE DEFENSE**
- **After receipt of preferential transfer, creditor advances new value to Debtor**
- **Encourages creditors to continue dealing with Debtor**
- **Requires money or money's worth conveyed to Debtor**
  - *E.G.*,
    - Jan 1 – Debtor borrows \$1mm from bank -- unsecured basis
    - Jan 10 – Debtor repays \$500k
    - Jan 30 – bank lends additional \$300k
    - Mar 1 – Debtor files
    - Can DIP/TEE recover \$500k payment?
    - Can only recover \$200k
    - Although Jan 10 payment was preference
    - Bank may assert defense that it provided subsequent new value -- \$200k
- **Sequence is important**
- **Same facts as above**
  - Jan 1 – \$1mm – unsecured loan
  - Now assume
  - On Jan 10, bank lends additional \$300k
  - On Jan 30, Debtor pays \$500k to bank
  - Mar 1 – filing date
  - DIP/trustee can recover entire \$500k
- **FORBEARANCE DOES NOT CONSTITUTE NEW VALUE**

## Monetary Limitation for Corporate Debtors

- Before 2005 BAPCPA, no monetary limit on debtor's ability to pursue preference
- 2005 BAPCPA -- business debtor cannot avoid transfers of less than \$5,000

## Assumption of Executory K

- Once Debtor assumes K, Debtor accepts K “as is” w/ all benefits & liabilities
- Therefore no preference action against non-debtor

# Fraudulent Transfers

- **In general, fraudulent transfer is a transfer of debtor's asset by debtor that is intended to avoid paying claims of debtor's creditors**
- **Fraudulent transfer laws designed to prevent debtor from divesting assets to detriment of creditors**
- **Also designed to promote Bankruptcy policy of equitable distribution of a debtor's assets among its creditors**
- **Fraudulent transfer occurs when debtor transfers an asset:**
  - (a) with intent to delay or hinder its other creditors ("ACUTAL FRAUD INTENT") or
  - (b) Without adequate consideration ('REASONALBLY EQUIVALENT VALUE') in return while
    - *Debtor is insolvent*
    - *Debtor became insolvent because of transfer*
    - *Debtor left w/ unreasonably small capital (i.e., Debtor left with insufficient assets to sustain operations) or*
    - *is rendered unable to pay claims of creditors*
    - (*"CONSTRUCTIVE FRAUD INTENT"*)

# Fraudulent Transfers

- **Actual fraudulent intent is difficult to prove – usually never any direct evidence**
  - **Because no direct evidence, courts look to several factors – “Badges of Fraud”:**
    - Transfer to insider -- usually applies to transaction with insiders
    - Debtor retained control over prop after transfer
    - Had Debtor been sued before transfer
  - **Insolvency of Debtor not relevant if actual intent found**
- **Under Bankruptcy Code, DIP or trustee may avoid Constructive Fraudulent Transfers occurring within 2 years of filing**
- **Prior to 2005 BAPCPA amendments, 1 year look back**

# Fraudulent Transfers

- **In addition to Bankruptcy Code, Debtor, trustee or estate representative (eg, Creditors' Committee) may rely upon applicable state law to avoid fraudulent transfers or conveyances**
- **State fraudulent transfer and conveyance laws generally have longer statutes of limitations – (e.g., NY -- Can look to avoid transfers -- occurred 6 years prior filing)**
- **Transfer must be of Debtor's property**
- **Property held in trust by Debtor for benefit of third party is not prop of Debtor's estate**
- **Examples of fraud transfers**
  - Intercorporate guarantees
    - *e.g., bank lends \$1mm to holding co.*
    - *sub guarantees repayment*
    - *1 month later, holding and sub files ch 11*
    - *can dip/tee of sub seek to avoid the guarantee as constructive fraud transfer?*
    - *was consideration provided by bank?*
    - *bank loaned \$1mm*
    - *but, did sub receive fair consideration?*
    - *constructive fraud transfer law looks to whether d (here, sub) received fair consideration*
    - *bank's potential arguments?*
- **Was sub insolvent when it provided guaranty?**
- **Were there any benefits to sub?**

# Section 363

- **It has been argued that section 363 is used to avoid requirements of plan and confirmation process.**
- Prior to enactment of 1978 Bankruptcy Code, courts disfavored sale of assets – either outside or through plan process.
- Only approved sale of assets if "emergency".
- 1978 Bankruptcy Code – section 363 provided an added means for sale of assets.
- Initially courts viewed section 363 sales narrowly
- Courts expressed emergency standard should still apply to:
  - *sales of all or substantially all assets*
- Trend began to change with seminal Second Circuit decision in Lionel Corporation chapter 11 case.
- In re Lionel Corp, 722 F.2d 1063 (2d Cir. 1983).
- Considered the most important decision in this area.
- Second Circuit chose not to adopt old emergency standard under section 363 sale.
- It further ruled, however, that before a section 363 sale is approved, a bankruptcy court must find an "**articulated business justification**" or "**good business reason**" for the sale.

## Section 363

- **Some factors to examine:**
  - Amount of elapsed time since filing
  - whether asset is increasing or decreasing in value
  - appeasement of creditors is not sufficient
- Sales under section 363 are now commonplace – *see* Lehman, Chrysler, GM.
- In practice -- mini-disclosure statement may be justified to support significant 363 sales.

- Undervalued Assets

- Probably the most compelling reason
- Assets are undervalued because of the overall distressed situation.

- The Auction Problem

- Virtually all bankruptcy sales are subject to higher or better offers.
- Creates potential issues for buyers:
  - *may never know until time of court hearing whether there will be competing bidders*
  - *at auction, creditors will attempt to increase total value being offered by bidders.*
- This may present problems for buyers who invest time, money and effort to conduct due diligence.

# How to Protect Potential Buyers?

- **Obtain bidding incentives**
  - These incentives must be reasonable:
  - Examples:
    - *require minimum incremental competing bids*
    - *e.g., any higher bid must be at least \$50,000 above current highest bid.*
    - *limited no shop provision*
    - *"break-up" fee (i.e., cash payment if assets are not sold to buyer)*
    - *generally, less than 3% of purchase price*
    - *"topping fee" (i.e., payment if competing bids exceed original bid by a certain amount)*
    - *reimbursement of expenses, etc.*
    - *bidding procedures require qualified bidders to meet certain criteria*
      - *must be able to consummate*
      - *require delivery of financials*
      - *must submit bids by strict deadlines*
- **It is important for interested buyers to have these incentives approved by bankruptcy court before beginning work on transaction.**
- **Generally, competing bidders have no standing to object to bid incentives.**
  - only creditors other parties in interest may object

# Sales to Insiders (e.g., existing management)

- Sales to insiders have long been treated with extra scrutiny; at one point, sales to insiders were absolutely prohibited.
- However, nothing in section 363 of the Bankruptcy Code prevents sales to insiders and courts have retreated from absolute prohibition.
- Nevertheless, courts still view sales to insiders with **stricter scrutiny** because of potential for conflicts of interest.

# Collusion

- Section 363 sales are subject to section 363(n)'s prohibition on collusive bidding.

- 363(n) allows a trustee to avoid a sale if sale price was controlled by an agreement among potential bidders

- 363(k) credit bid rights
- Bankruptcy Code allows secured creditors to bid the amount of their claim in full.
- Secured creditor may offset claim against purchase price it bids for assets.

# Steps to Confirm A Ch. 11 Plan

- Negotiate plan (“POR”) with creditors (or their agents)
- Draft Term Sheet
- Draft POR and "disclosure statement"
- Get court approval of "disclosure statement"
- Only after get disco stmt approval, solicit votes from holders of “impaired” claims
- Count the votes
- Ask court to confirm POR

# **NEGOTIATING POR**

- **During negotiations, 2 rules that empower owners and managers:**
  - DIP'S exclusive right to propose POR, and
  - right to classify creditors' claims and equity interests
- **Among creditor plan protections:**
  - feasibility and
  - best interests of creditors tests
- **Negotiations usually culminate and result in term sheet**
- **Term Sheet describes key business points**
- **POR merely memorializes deal**
- **POR not always cash to creditors**
- **May offer debt or equity securities**
- **Outside bkcty, issuance securities – expensive & time consuming**
- **Need Federal & State registration**
- **Ch 11 exempts issuance of securities under POR from registration requests**

# WHO CAN PROPOSE PLAN?

- § 1121 tells us who can propose POR
- “Exclusive period”
- DIP has exclusive right to propose POR for first 120 days of case
- If DIP files POR during that time, period when nobody else may file POR is extended to 180 days
- This enables DIP to solicit acceptances – “solicitation period”
- May extend exclusivity and solicitation period – Showing of “cause”
- May not extend beyond 18 months
- Solicitation period - not extend beyond 20 months
- After exclusivity expires, ANY OTHER PARTY may propose POR
- EXCLUSIVITY offers:
  - *DIP’s managers and owners chance to participate in value of reorganized firm*
- Pre 2005 BAPCPA Amendments, DIP could get unlimited extensions

# Disclosure Statement

- Without Court approved disclosure statement, debtor may not solicit creditors to vote on POR
- § 1125 deals with requirements for d/s
- If Court determines d/s is adequate in description of POR, proponent may then solicit acceptances for POR
- D/s must contain sufficient information to enable creditor to cast rational vote
- D/s need not talk about alternative possible or proposed plans
- Because of feasibility and best interests tests, d/s require, at least provide:
  - *historical financial statements;*
  - *financial statements forecasting future performance (pro forma);*
  - *statement of assumed conditions upon which pro forma statements are based;*
  - *description of claims and interests dealt with POR, including amounts; and*
  - *listing of assets, with all info relevant to their value in liquidation proceeding.*

# Contents of POR

- **Governed by 1123**
  - 1123(a) – mandatory provisions
  - 1123(b) – permissive provisions
- **Voting requirements and classification**
- **1123(a) requires -- POR must classify claims of creditors and shareholders into classes**
- **Can only classify claims together if they are "substantially similar"**
  - e.g., all trade creditors can be classified together and treated similarly
  - Typically, each secured creditor is given own class
- **Bankr. Code doesn't say whether can classify claims that are "substantially similar" in separate classes**
- **This is often helpful in trying to achieve required votes**
- **Each class of creditors votes as a unit**
- **Class is deemed to accept POR if**
  - more than 1/2 number of class members and
  - at least 2/3 in amount of claims vote to accept
- **Among shareholders,**
  - vote of 2/3 of amount is sufficient
- **Note – applies only to those voting (not "of all creditors")**
  - E.G, if 200 creditors in class and only 10 cast ballots
  - majority in number if 6 YES votes
  - Also, if claims total \$1MM and only claims aggregating \$100K return ballots
  - then you have 2/3 in amount if \$67K in claim vote yes

- **Voting rules may dictate how creditors will be classified**
- **DIP will want to create classes according to voting rules**
- **Statutory law says only creditors with similar legal rights may be placed in same class**
  - e.g., Secured creditors different legal rights than unsecureds
  - priority creditors different legal rights than unsecureds
- **Statute does not say whether similar claims may be placed in different classes**
- **General standard – DIP broad discretion to separately classify similar creditors, so long as there's business justification**
  - business reasons – loyal trade vendors paid greater percentage b/c continue to do business
- **Creditors cannot be classified solely on basis of their support or opposition to POR**

# Leaving Class Unimpaired

- POR must list classes
- POR must also state if class of claims are impaired or not
- Important because POR proponent need not obtain acceptance of “unimpaired” class
- § 1126 -- need not even solicit votes of creditors in unimpaired class
- Such creditors conclusively presumed to accept
- IMPAIRED CLAIMS -- If POR alters rights CREDITORS would otherwise have, CREDITOR IS impaired
- Creditor entitled to immediate payment is impaired if must wait even few days
- Creditor entitled to installment payments is impaired if terms are changed even little

# Criteria for Confirmation

- **GOVERNED BY 1129**
- Best interests test – 1129(a)(7)
- Once you have class voting in favor, can impose POR on dissenters in class
- Dissenters, however, are entitled to protection
- One important exception to this important rule:
  - *Dissenting creditor (even one in consenting class) may defeat confirmation if can show would receive more in chapter 7*
  - *This is "Best Interest" test*
  - *In chapter 7, assets sold and distributed*
  - *Secured creditors paid 1<sup>st</sup>*
  - *Priority and admin claims next*
  - *Unsecureds next*
  - *Equity last*

# Other Confirmation Criteria

## FEASIBILITY – 1129(a)(11)

- Tests whether POR is proposing more than DIP's operations and current cash position will support
- requires ct find DIP is likely to be viable if POR is implemented
- WORDS OF STATUTE:
  - *Confirmation of plan is not likely to be followed by liquidation, or need for further financial reorganization (unless such liquidation or reorganization is proposed)*
- Court must find REORGANIZED DIP is likely to generate cash it needs
- Feasibility test requires evaluation of:
  - *anticipated cash needs of reorganized DIP under POR and*
  - *Sources of cash avail to meet those needs*
- Administrative expenses –
  - *paid in cash, unless holder of administrative expense claim agrees otherwise -- 1129(a)(9)*
- Unpaid obligations to DIP lender have to be paid or refinanced
- Priority taxes -- paid in full, with interest, over no more than 6 years from date tax assessed -- not from date POR is confirmed
- Priority claims – include wages, contributions to employee benefit plans and consumer deposits, up to certain dollar limits
- Priority claims can be placed in classes and paid over time, but only in full, and only if the class accepts

# Sources of Cash

- **Feasibility test requires consideration of sources of cash needed to satisfy POR's requirements**
- **How firms acquire case:**
  - capital contributions by equity owners;
  - selling assets;
  - borrowing; and
  - earning revenues from operations
- **Court must decide whether DIP likely to generate enough cash (in addition to cash on hand) to timely fund its operations and obligations under POR**
- **Difficult assessment. Requires consideration of operating performance and projections of future performance, or pro forma financial statements**

# Additional Confirmation Criteria

## At least 1 class of impaireds voted yes

### 1129(a)(10)

- Cram Down

- what happens if debtor cannot get agreement of all impaired classes?
- 1129(a)(8) – to confirm need all impaired classes to vote yes
- Under certain circumstances, POR may be confirmed even if 1 or more impaired classes voted against it
- Bankruptcy Code permits proponents of POR to “cram down” POR on dissenting class(es) if
  - POR is deemed by Court to be fair and equitable to that class
- Before get to Fair & Equitable, need at least 1 accepting class before may cram down
- 1129(A)(10) – “somebody has-to-like-it-test”

# Additional Confirmation Criteria

- **Fair and Equitable**
- **Code sets out tests for fair and equitable treatment**
- **Depends on whether class is secured, unsecured or equity ownership**
- **Cram down secured creditor**
- **Fair and Equitable Treatment of Secured Claims**
- **In essence, POR must provide creditor full value of lien rights**
  - 1<sup>st</sup> – determine value of collateral
  - POR distributions to creditor must have discounted pv equal to value of collateral

# Cram Down class of unsecured creditors (or a secured lender with deficiency claim)

- **Apply absolute priority rule**
- **No junior class can receive anything on account of pre-bankruptcy claims unless senior classes paid in full**
- **Cramdown of class of unsecured creditors requires strict adherence to Absolute Priority Rule (“APR”)**
- **Exceptions:**
- **Senior class may carve out portion of its recovery for benefit of junior class**
  - Armstrong Industries decision (Third Circuit) – class of unsecureds gifted warrants to old stockholders
  - another class of unsecureds objected
  - Court held not appropriate
  - other courts have allowed secured creditors to give portion of their recovery to junior classes
    - *eg, SPM – secured creditor gave value to unsecureds*
    - *priority tax creditors objected*
    - *Court rule this ok*

# New Value Exception to APR

- Stockholders can retain interest in reorganized entity if contribute money or money's worth
- “New value exception”
- Exception to principle of APR