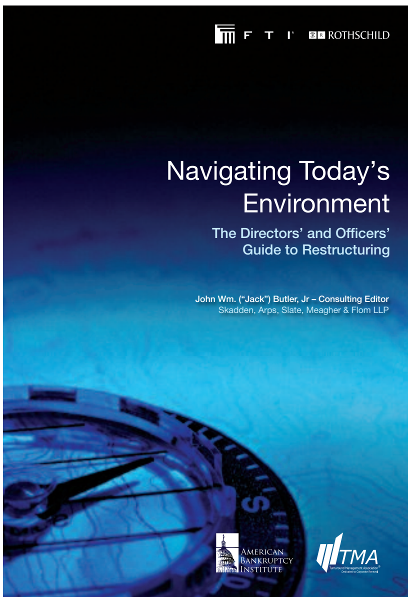


Does reorganization need reform? Time for a new look at Chapter 11

Robert J Keach, Co-Chair of the Business Restructuring and Insolvency Practice Group, Bernstein Shur, writing on behalf of the
American Bankruptcy Institute

After over 30 years, does Chapter 11 need reform? Ironically, at a time when other countries have just started to borrow Chapter 11's best elements for their own insolvency regimes, the statute is undergoing a period of re-examination in its country of origin. Recent events — perhaps reaching a nadir with the Chrysler and General Motors cases — have many calling for a fundamental re-examination of the system of corporate restructuring in the United States.

Chapter 11 — the "orthodox" model

The "orthodox" model for a Chapter 11 — ushered in by the 1978 Bankruptcy Code — involved a debtor voluntarily seeking relief, largely to address balance sheet issues and often short-term or one-time operational disruptions (mass tort litigation, product issues, accidents, natural disasters etc). Under the central feature of the Code, the debtor and its existing management remained in possession of the debtor's assets and in control of its reorganization, albeit under court supervision. The debtor in possession (DIP) would negotiate with its existing lender (or a new DIP lender or even several potential DIP lenders in the recent 'golden age' of liquidity) for DIP financing.

Once the business was stabilized, the debtor would negotiate its plan of reorganization with its various creditor constituencies, including a creditors' committee of trade creditors and bondholders, most of whom held their claims and had a long-term interest in the debtor's survival, either because they wanted a customer to sell to or simply because their best hope for a decent return on their claims lay in the debtor's recovery and survival.

Debt was often exchanged for equity, but existing equity often kept a small piece of the action as well. A plan was developed, sent to all creditors and voted on by creditor classes. Rarely, cramdown (confirmation over objection) occurred. Cases often took years, with little pressure to emerge from the protective cocoon of Chapter 11 until all of the balance sheet and operational issues were resolved. There were some sales of all of the assets — Section 363 sales — but they were by no means the norm. The principles of creditor democracy, equality of distribution among like creditors, absolute priority and fundamental fairness — along with a fresh start for the debtor — were paramount.

Restructuring in a changing world

The 1978 version of Chapter 11 was seen — and often criticized by creditor groups — as "debtor friendly" or, at least, as reorganization friendly. The degree to which it succeeded in saving businesses, as well as the jobs they provided, was often debated. But, in the case of the larger firms, it largely met the announced goals of its originators. Or at least, it did for a time.

The world of credit — and restructuring — has changed a lot since 1978. Secured credit appears at multiple levels of the balance sheet, with first lien, mezzanine and third lien debt. Debtors now often arrive at Chapter 11's door seriously over-leveraged, with little or, often, no equity in their assets after payment of the secured claims. The situation where there is value to distribute to even

priority creditors, such as employees, is increasingly rare. Indeed, many cases — even very large cases — flirt with administrative insolvency from their earliest stages, meaning that, without a "gift" from the secured lenders, the costs of the Chapter 11 case itself cannot be met.

An efficiently functioning market for distressed debt, even for small unsecured claims in middle-market Chapter 11 cases, steadily emerged. Creditors no longer needed to wait for a distribution from the estate if they wanted a return on their claims; they could simply sell them, albeit at a discount, to a willing claims trader.

The face of lenders changed, too. Many (most) loans are not made by "traditional" lenders (the banks), but rather by private equity funds, hedge funds and others — when they are made at all. The new class of lenders often had very high expectations for rate of return, and very little patience for an underperforming borrower. Unlike their state- and federally-regulated predecessors, the new lenders were also willing, and sometimes anxious, to take over a struggling borrower entity.

Changes to the Bankruptcy Code

The Bankruptcy Code has also changed over time, as various special-interest groups gained advantages. Prior to 2005, there was little in the way of comprehensive reform, but rather a series of incremental changes. The 2005 legislation (known as BAPCPA) introduced what many consider to be the most devastating changes to the cause of traditional restructuring — changes that others defended as a necessary tilt towards the rights of creditors. Landlords obtained shorter maximum periods to assume or reject leases. New administrative expense categories were created, including for suppliers. And utilities obtained increased rights, which further stressed liquidity.

Swaps, repurchase agreements and forward contracts and other derivatives, which previously had some limited protection, were essentially carved out of the Code, with counterparties allowed to terminate the contracts free of the automatic stay and insulated from avoidance action risk. The definition of those contracts and instruments included within the category of the exempted derivatives was broadened widely in 2005. In sub-prime mortgage company cases like New Century and American Home Mortgage, the bulk of the assets left the bankruptcy estate within days of filing — possessed and either retained or sold by warehouse lenders, the counterparties under master repos and similar constructs.

In response, transactional lawyers and their counterparty clients also began adjusting to the breadth of the derivative safe harbors — recasting loans as master repurchase agreements and supply contracts as forward contracts. The new, expanded provisions were being used, arguably, not just to protect the functioning of public markets — their original announced purpose — but rather to "bankruptcy proof" otherwise routine secured lending and commodity supply arrangements.

Labor made some legislative gains in the 2005 amendments, particularly in the area of limiting retention bonuses and executive compensation. Retention pay programs were sharply curtailed, if not virtually outlawed, especially for senior executives. But for the most part, labor contended that the changes to Chapter 11 operated to the detriment of workers.

Financing and sales

Through case law development and practice, DIP financing got more onerous, with lenders obtaining more control. Case law had previously prohibited, or at least severely curtailed, the practice of cross-collateralizing pre-petition secured debt with new post-petition assets. However, this practice, perfected in a DIP financing structure known as a "roll-up", became commonplace (in a roll-up, the DIP financing "pays off" the pre-petition loan, while the entire balance of the "new" financing, which often involves minimal new money, is secured by a first-position lien in all pre- and post-petition assets). Lenders also sought and obtained broad releases, which were also limited under prior case law. More critically, Chapter 11 cases began to look like streamlined foreclosures, as DIP financing deals added tight deadlines by which the debtor's assets needed to be sold or the financing would end.

Sales — very quick sales — became the norm for highly and over-leveraged debtors arriving in Chapter 11. Sales of substantially all of the debtor's assets, free and clear of liens, were completed, often within 30-60 days of the filing of the case, if not a shorter period, with the buyer sometimes being the hedge or private equity fund that was the pre-petition and DIP financing lender.

These so-called "loan to own" deals became more and more common, while also attracting increasing scrutiny.

In the quick sales transactions, collective bargaining agreements were often rejected. In a number of cases, the sales price was less than the secured debt. Debate raged over whether the lender should carve out money for the junior classes of

debt, sometimes derisively referred to as the secured party's "tip" for use of the bankruptcy system to foreclose on collateral.

Chrysler and General Motors

Then came the Chrysler and General Motors cases. In both, the US and Canadian governments were pre-petition lenders and the DIP financing sources. The central assets of two of the world's largest automakers were sold, within a couple of months of the case filings, in each case to a "new" company largely owned by the governments and by labor union affiliates, the latter having earned stock in the new entity by virtue of agreeing to new, company-friendly collective bargaining agreements and pension arrangements. Many dealer agreements were rejected to devastating effect, closing down a number of Main Street businesses. Tort claimants — the alleged victims of accidents caused by allegedly defective vehicles — were largely left to recover from the unsold residual assets, as were other classes of unsecured and under-secured debt, although there were variations between the two cases in this respect. Both were essentially large loan-to-own cases, the US government standing in the role usually occupied by a hedge fund or bank lender.

Commentators — and others — rushed to declare a possible new era for restructurings, while at the same time pleading that the automaker cases be treated as "one-offs" and a product of unique government intervention necessary to save the struggling, and critical, US auto industry.

While Section 363 sales of all or substantially all of the debtor's assets were, as noted above, nothing new, many saw Chrysler and GM in particular as having cast aside the concepts of creditor democracy, equality of distribution, absolute priority and fairness. They contended that Chrysler and GM had the potential to usher in what may be called the "sale model of reorganization".

In that model, arguably, creditors participate in the reorganization based upon what the purchaser sees as their capacity to contribute to the survival, indeed success, of the new post-Chapter 11 enterprise.

Those that do not are left to divide up the residual assets. Defenders of the Chrysler/GM results declare them nothing new or radical, but simply large Section 363 sales of the typical variety.

Addressing the questions

Questions abound. Is Chapter 11's demise greatly exaggerated? Is the market — and the creativity of the practitioners — outrunning the legislation? Is it simply time for a reset, a re-examination of the Code after 30-plus years in light of these developments? Should we save "orthodox" Chapter 11, and could we if we wanted to? What should the "new" Chapter 11 look like? Back to the future (save bootstrap reorganization) or brave new world (sale model)?

The American Bankruptcy Institute (ABI) joined the examination of these issues through a symposium entitled "Chapter 11 at the Crossroads: Does Reorganization Need Reform?" on November 16-17, 2009 at the Georgetown University Law Center, Washington, DC.

At this event, the ABI invited some of the finest minds in the insolvency community — academics, practitioners, and jurists — to participate in a discussion of eight, distinct Chapter 11 reform topics. The questions that were discussed highlight the scope of the issues requiring discussion and consensus:

A re-examination of the original 1978 code: strengths, weaknesses and what amendments may have done to the balance of the "original" code

This segment of the symposium examined the structure and philosophy of the original Bankruptcy Code and studied whether or not they remain viable and functional in light of the changes to secured lending and the credit and distressed debt and asset markets. The panel also looked into whether or not the numerous creditor-friendly amendments to the code destroyed or (as creditors would argue) restored its balance. Were the amendments a necessary response to an overly debtor-friendly regime, or overkill, leaving the statute unable to achieve its goals? Is it as simple as going backwards, or is more comprehensive reform required?

Legislative impediments: should the BAPCPA changes be rolled back?

This panel discussion focused on four specific changes made by the 2005 amendments. First, Section 503(b)(9), which created an administrative claim for suppliers that had shipped goods within 20 days of the petition date. Critics of the provision claim it has contributed to administrative insolvency and made it more difficult to reorganize. Proponents defend it as a much-needed protection for suppliers, especially when state-law reclamation rights are often rendered worthless by blanket liens in inventory and receivables held by asset-based lenders.

Second, the changes limiting the maximum

time period for the debtor to decide to assume or reject commercial real property leases.

Critics allege that this provision has almost single-handedly killed retail reorganizations, and point to cases like Circuit City as evidence of same; lenders are alleged to have reacted to the possible early loss of leases by compelling early liquidations. Defenders of the change argue that it brought needed balance to the statute, since the prior provisions often lead to courts extending the time to assume or reject leases for years, leaving landlords in limbo.

Third, the panel looked at the cap on the debtor's exclusive period to file a plan of reorganization. Are creditors now better able to "wait out" the debtor, leading to more liquidations?

Fourth, the provisions outlawing key employee retention plans were examined. Have the provisions helped thwart reorganizations by making debtors powerless to retain critical management personnel or were they a much-needed change, merely preventing insiders from enriching themselves at the expense of other creditor constituencies despite no demonstrable retentive purpose or effect?

Do the provisions regarding forward contracts, swaps, repurchase agreements and other derivatives need reform?

This panel focused on the so-called "safe harbor" provisions. These allow non-debtor counterparties to forward contracts, swaps, repurchase agreements and other like contracts to terminate the contracts and liquidate the underlying assets without first obtaining relief from the automatic stay in bankruptcy. They also largely insulate such counterparties from any risk that the exercise of remedies, pre- or post-bankruptcy, will be subject to avoidance by the debtor, a trustee or a creditors' committee. Critics contend that, especially after the 2005 changes, these safe harbors extend to far too many transactions, many of which have no connection to public markets, resulting in the bankruptcy estate being deprived of valuable assets at the outset of the case, with little or no ability to insure that the value of such assets is maximized. Proponents contend that the provisions are essential to the smooth functioning of the markets in such instruments.

Labor issues: would reform of Code provisions and related federal law regarding employee and labor claims and actions in Chapter 11 help or hurt reorganizations?

This panel focused discussion on proposed changes to the Bankruptcy Code set forth in HR 3652 (also known as the Conyers Bill, after its sponsor) and sought by labor unions. (Labor has since introduced similar legislation.) Among the many labor-friendly aspects of the Conyers Bill, the legislation would make it much more difficult to reject collective bargaining agreements under Section 1113 of the Bankruptcy Code. The Conyers Bill would amend Section 363 to provide that courts, in approving sales, would be required to consider the extent to which the bidder has offered to maintain existing jobs, preserve retiree benefits and assume defined benefit pension plans in determining the "highest and best" bid. It would also create a $20,000 per retiree surcharge on sale proceeds in certain sales.

The proposed changes include the ability to surcharge secured party collateral for payment of wages and benefits. The standards for confirming a plan would be amended to require consideration of whether the plan proponent made every reasonable effort to maintain jobs and mitigate losses to employees and retirees, and would require — in the context of competing plans — confirmation of the most labor-friendly plan. The Conyers Bill would also place several additional limits on executive bonuses and executive compensation in Chapter 11 cases.

Critics contend that the changes would make reorganization far less likely. Labor contends that the changes are essential to ensure that employees are not left empty-handed under modern restructuring regimes and structures.

Financing and cash collateral: too much control to the lenders (and what can we do about it anyway)?

This portion of the symposium examined whether pre-petition and DIP lenders are acquiring far too much control via DIP financing agreements, and whether, if so, the cause of such control lies in changes to secured lending generally or a more liberal approach to such control by the Chapter 11 constituencies. Possible statutory changes to ban such provisions were considered. Critics of the "modern" DIP lending agreements contend they have too often turned Chapter 11 into a foreclosure mechanism. Lenders contend that the provisions are necessary given the typical balance sheet of the modern candidates for Chapter 11 relief.

Who should run the Chapter 11 process?

This discussion focused attention on the continuing viability of the debtor in possession/creditors'

committee structure for reorganization. Should the management that brought the company to Chapter 11 stay in place to guide the restructuring? What skills does that management bring to the table if the company is going to be sold in any event? Given that claims are often traded — with the "trade creditors" exiting the case early via the sale of their claims to distressed debt traders — does the creditors' committee still work as an ally of, and also a check and balance to, the debtor in possession? Should the US look at Canadian and European regimes and more often employ an independent third party to monitor, if not administer, the Chapter 11 case?

The present and future of the "one size fits all" approach of current Chapter 11: do we need a Chapter for the "too big to fail"?

While proponents of Chapter 11 reorganization maintain that it should have continued to be the nearly exclusive venue for restructuring "too big to fail" entities like Chrysler, CIT, GM and Lehman Brothers, Congress recently rejected this view when it adopted the Dodd-Frank Act. The Act includes provisions that create "resolution authority", the ability of the government to take over and restructure, sell or merge large non-bank institutions, the failure of which poses "systemic risk". The closest model to this new resolution authority is the federal bank receivership, under which the FDIC seizes control of troubled banks and often merges them with, or at least transfers deposits and other key assets to, healthy banks.

The sale model of reorganization after Chrysler, GM and Lehman: Evolution or demise of Chapter 11?

Finally, this panel examined whether or not the auto cases really do portend a new model for restructurings, one that uses Section 363 not only to sell assets but to accomplish restructurings using a buyer controlled by some, but not all creditor elements of the existing debtor. The panel considered whether or not this model is fair, or whether it is unduly prejudicial to excluded creditor groups and abandons long-held principles of creditor democracy, absolute priority and like treatment of similarly situated creditors.

The discussion also focused on legislation proposed by some commentators that would limit the use of Section 363 sales of substantially all of the assets of the debtor and/or would import into that process elements of disclosure, creditor democracy and fair and equitable treatment that are now mandated in connection with the confirmation of Chapter 11 plans.

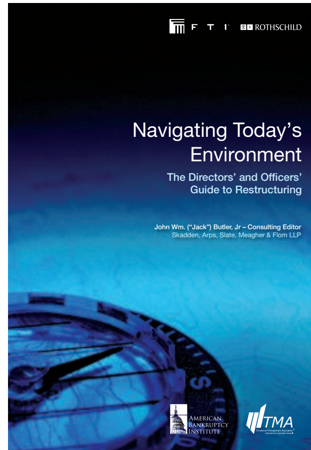
The symposium was not a mere academic exercise. As noted, bills have previously been introduced in the US Congress on a host of proposed labor and employment reforms to Chapter 11, as well as to repeal the BAPCPA provisions affecting business reorganizations. The reintroduction of those efforts is expected.

Conclusion

While the crowded legislative calendar likely prevents bankruptcy reform legislation from being adopted in the current Congress, the press for Chapter 11 reforms will not go away, fueled by a possible flood of new Chapter 11 cases to come, as the Great Recession continues to leave its wake. The list of parties claiming to be "losers" under the current insolvency regime could grow, followed by requests for legislative redress.

Moreover, this debate is set to continue for some time. Indeed, in this respect, the years following the recession of 2007-09 could be as historic as the recession itself. Examination of the Bankruptcy Code, as it now functions, could bring a call for fundamental changes to the insolvency regime, whether change comes merely in the form of a "back to the future" approach that restores what so many saw as the perfect balance of the 1978 Code, or in amendments that accept that the sale is the dominant model and attempt to soften the blow of such transactions.

If 2005 swung the pendulum toward creditors' interests, will the next round of legislative changes portend a return swing toward debtor rehabilitation? Regardless of the approach, and the precise timing of reform, the basic blueprint of US restructuring is likely to look different before too long.



Grouped into seven sections, Navigating Today's Environment consists of 45 separate "conversations" with the leading restructuring voices of our generation. Much of the knowledge and experience conveyed in these pages is relevant to leaders of public and private companies of all sizes, whether small-cap, middle-market or Fortune 1000. Navigating Today's Environment is a resource guide for US officers and directors, as well as those who are interested in and follow the management and corporate governance of US companies.

This publication is intended to provide a general guide to business and legal practice. The information and opinions that it contains are not intended to be a comprehensive study or to provide specific professional advice, and should not be treated as a substitute for such advice concerning particular situations. Legal and/or other professional advice should always be sought before taking any action based on the information provided. The content reflects the individual views of the authors, and those views are not presented as those of their firms, other contributors or the editors. The publishers, sponsors and authors bear no responsibility for any errors or omissions contained herein.

To view the book in which this chapter was published, and to order hard-copy versions, please go to: www.navigatingtodaysenvironment.com

Published by Globe White Page Ltd. © Globe White Page 2010