CORPORATE REORGANIZATION UNDER BANKRUPTCY LAW IN THE UNITED STATES OF AMERICA

Prof. Leland L. BULL, Jr.
Detroit Hukuk Fakültesi

It certainly is non secret that the ecoomies of the western industrial nations are in trouble and that some of our major, as well as many of our minor, companies are in trouble too.

Whenever a company falls into difficulty, the possibility of *bankruptcy* arises. Let's consider what bankruptcy traditionally means : the closure of the company and the liquidation, at scrap values rather than at going - concern values, of the assets of the business, with loss of jobs for the employees and consequent higher social costs for the state, loss of a customer for its suppliers, and loss of a source of supply for its customers.

It's no wonder, then, that, when a major company threatens to file bankruptcy, politicians, emloyees, stockholders and others directly affected scream for relief from the public purse.

Proposals are frequently made for state aid to the ailing business; what this means, of course, is simply that the public as a whole should pay for saving the interests of those directly affected by failure of the company. I have read, for example, the headlines in US newspapers concerning proposals for salvaging the European steel industry by state aid, and I know that this has been a major topic of conversation here in Europe.

A question was recently posed to me by a European bankruptcy scholar concerning legal problems involved in granting state aid to financially troubled private enterprise in the United States. In

formulating my reply, I thought for a moment and realized that we have had only two widely publicized such cases on the national level in recent years : Lockheed Aircraft Company and the Chrysler Corporation. I believe that this is so in substantial part because the American bankruptcy law known a statutory reorganization proceeding for the past fifty years, which proceeding allows for the restructuring of an ailing company, if at all possible, within the forum of the Bankruptcy Court and outside of the political arena.

Consequently, many of the problems of insolvent American companies have been dealt with within the court system and not in Congress. Only in the two cases I mentioned were political question *too* large for a court solution (or a non - court, private - sector arrangement with creditors). In the Lockheed case, the argument was made that Lockheed, as one of the country's largest military goods contractors, could not be alowed to fail. At the time, Lockheed was producing the C5A, the United States, Air Force's primary long - range transport airplane. But Lockheed's problem was the failure of its civilian jumbo - jet program, the L1011. Due to tremendous pressure from politically powerful congressmen, a special law was passed, by which the US government guaranteed $ 300 million of bank loans. The company did not fail; it ultimately closed its L1011 program, wrote off its L1011 losses, and survived as an entity. But the question should be raised whether the precedent was appropriate. In a bankruptcy reorganization, essentially the same thing would have happened, except that the successful defense work would have been sold off or otherwise have suvived, saving those jobs, and the L1011 program simply ended sooner, with only a slightly earlier loss of its jobs. The net affect, then, was to give aid to the *stockholders*, who normally bear the greatest risk of failure. Losses were simply shifted to the public as a whole by virtue of the costs to the government of the loan guaranty.

In the Chrysler case, the government actually granted $ 1,500 million in low interest loans to Chrysler. At the same time, Chrysler sold off nearly every non - automotive division of the company, including its successful defense industry facilities and its foreign subsidiaries; it forced concessions from its unions and its suppliers

and cut nonunion employees' pay by 10 percent or more. The company survived, but the cost to the taxpayer by the government borrowing money at market rates to loan to Chrysler at below market was significant. Certainly there are two sides to every issue; it can well be argued that the potential social cost in loss and relocation of jobs at Chrysler, one of America's largest half dozen manufacturers, and its many suppliers, created a problem simply too large to handle in a bankruptcy case. Still, I question whether Chrysler's survival in pared-down form might not have been achieved by proceedings before the Bankruptcy Court in a reorganization case. As it was, the government *did* extract a price for its aid - in return for the money loaned, warrants for the purchase of new stock in the company were issued to the U.S. Treasury. The government later sold these warrants at a profit and recouped *some* of the costs of the interest subsidy (though not enough to cover the subsidy *in toto*). When the warrants were exercised to purchase new stock, the interest of the original shareholders in the company was, of course, somewhat diluted. Thus, in this case, where the rescue was successful, the stockholders, the persons upon whom the risk of loss *should* fall in the first instance, did suffer some dilution in their ownership interests.

Of course, the legal opportunity for a restructing in bankruptcy does not guarantee that the restructuring, that is, the reorganization effort, will be successful - but it does certainly reduce some of the pressure for *ad hoc* political solutions, which often mean that public monies are used in an uneconomic effort to save jobs (which may be socially justifiable in the short run), or to save investors from loss of their investment (which I do not believe can be justified socially or economically)[1].

Since bankruptcy liquiaditon usually means terrible economic loss for most of the parties concerned, and because the problems caused by *ad hoc* political solutions (as well as their lack of per-

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1) In fairness I must admit thau the US Government does subsidize bankruptcy reorganization in one sense: Special provisions of tax laws forgive taxation of the income created by the discharge of indebtedness in bankruptcy proceedings.

manence) are often worse than the disease itself, European lawyers and parliamentarians have been taking a close look at the US reorganization law with a view of adopting some of its practices into reorganization statutes in their own countries. The coutry in which this process has progressed furthest is the Federal Republic of Germany, where the fact-finding and study stage is coming to an end and the statute drafting stage is beginning. The present German government hopes to present a draft reorganization statute within a year and to pass such a statute before the end of the present legislative period.

Within these comments as an introduction, let me direct some remarks to the subject of reorganization in the US.

The goal of our reorganization proceeding, the rules concerning the conduct of which are now codified in Chapter 11 of the United States Bankruptcy Code of 1978[2], is to realize the remaining economic value in a distressed company and to make it available to the various classes of secured and unsectred creditors, and to the equity owners (ie., the stockholders), according to *strict priority rules,* by which secured creditors must be paid off first, then the unsecured and then, and only then, the stockholders. That means, under the absolute priority rule, precisely that the stockholders of an insolvent company, after the reorganization, will retain absolutely no interest in the company unless the creditors voluntarily accept a plan of reorganization under which their recovery is reduced in order to preserve some value, however, small it may be, for the company's pre-reorganization stockholders. Hence, the first point to be made is that reorganization may mean, at least for the publicly traded corporation, more than simply a *compromise* of indebtedness with the company's unsecured credi-

2) The Bankruptcy Code contains separate charters for both liquidation and reorganization proceedings, as well as provisions applying both in liquidation and reorganization for administration of the debtor's estate and for the avoidance of prohibited transfers. A reference to "bankruptcy" should be understood asapplying to both liquidation and reorganization proceedings; a reference to "reorganization" means that the provision under discussion applies only to reorganization cases.

tors; it often will include a partial or complete change in ownership, with former shareholders' stock cancelled, and the former creditors receiving all or most of a new issue of stock in full or partial satisfaction of their claims[3].

Let's take a look at how the reorganization proceeding works, citing a few of the highlights :

1) A reorganization case under Chapter 11 may be, and usually is, begun by debtor's management filing *a volutary petition for reorganization*. There are absolutely no legal or economic conditions precedent, such as balance sheet insolvency or suspension of payments, which must be fulfilled before a bankruptcy petition may be filed by the debtor. In other words, our law places no legal impediments to filing in bankruptcy upon that management which concludes that its company is in serious economic trouble. There are also no circumstances which *compel* management to file a petition in bankruptcy.

The consideration behind this freedom to file or not to file is that a reasonable management will file for reorganization while there still remains some economic viability in the concern which can form a basis for a successful reorganization[4].

2) One aspect of af reorganization case which is often misunderstood by foreign observers is that the debtor's estate is usually managed during the proceedings by the debtor itself as "debtor - in - possession" ("DIP"). A trustee is not appointed unless debtor's management is guillty of pre- or post - bankruptey fraud,

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3) In mentioning this possibility of the capitalization of debt as stock, I should caution that this eventuality is normally restricted to companies, the stock of which is publicly traded and in respect of which an after - market for such stock issues is likely to exist.

4) Involuntary proceedings are, of course, always available on creditor petition. If controverted by the debtor, the creditors' petition can be granted by the court only if the judge finds that the debtor is functionally insolvent, that is, if it has ceased paying its debts, or if control of a substantial portion of the debtor's assets has passed to a liquidating agent.

mismanagement or incompetence[5]. The philosophy behind this provision, which remains somewhat controversial, is that the added cost of a trustee, and the time lost for a trustee to familiarize himself with the debtor's business during the crucial first few days of a case when far-reaching decisions affecting the debtor's future viability must be made, outweigh the risks in the average case that the debtor, as DIP, will despoil the estate. The law contains safeguards limiting the freedom of action on the part of the DIP, such as (1) permitting the court of appoint an examiner to inquire into the causes of the bankruptcy and report his findings to the creditors and the court, (2) requiring court approval ,after notice to creditors, for any actions taken by the DIP outside the scope of normal business transactions, (3) requiring extensive monthly reporting to court and creditors of the results of the conduct of the debtor's business, and (4) providing for a creditor's committee with the power of oversight over debtor's operations. It is the creditor's committee, incidentally, as much as the court and the debtor's own attorneys, which, in its role of overseeing the debtor's functions, acting as a representative of creditors interests, and serving as a communications bridge between debtor and the creditors body, can spell the difference between success and failure of a reorganization case.

3) The right of secured creditors to recorver from the debtor's estate the property forming their security, or to force its sale in satisfaction of their secured claims, is suspended by an automatic stay against all such efforts subsequent to the opening of the bankruptcy. This stay is imposed pursuant to § 362 of the Bankruptcy Code and remains in effect throughout the course of a reorganization case unless lifted by the Bankruptcy Court upon application of the secured creditor. Let us consider further the purpose and function of this stay of enforcement of security interests and other property rights.

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5) A trustee may be appointed at any time before a plan of reorganization is confirmed, on application to the court by a party with an interest in the case, upon a showing of fraud, mismanagement or incompetence, or if the court concludes that a trustee's appointment would be in the best interest of the creditors of the estate.

Initially, it is obvious that, in obtaining credit, the debtor will almost always grant a security interest in its plant and equipment, in its inventory of raw materials and finished products, and in its accounts receivable from customers. It is also obvious that most of these assets, and particularly the machinery and equipment, are essential to the debtor for its continued survival; a company cannot operate if its machinery and equipment have been seized by its secured creditors. Hence the enforcement of security interests at the outset of a reorganization proceeding will ordinarily bring a quick end to the debtor and to the reorganization attempt itself; there simply won't be anything left to reorganize.

However, even though secured creditors may be forced to leave their collateral, that is, the assets securing their loans, with the debtor for further use in its operaitons, they are not without protection of their interests in the debtor's property. In fact, they are entitled by the United States Constitution to protecion of their property rights (that is, their security interests in the collateral) during the course of the proceedings. This protection is granted as follows :

If their collateral is worth less than the amount of their claim, they must be granted interim payments, called "adequate protection" payments, to reflect the depreciation of their collateral while it remains in the debtor's hands during the course of the proceedings. This statement, in the abstract, may be hard to understand. To illustrate : Suppose the debtor has granted a security interest in a business vehicle worth at the time of bankruptcy $ 20,000, which security interest is to protect a claim of $ 25,000. It is obvious that the full value of the vehicle is subject to the creditor's claim (one can say that the creditor's *secured* claim is $ 20,000, while his remaining $ 5,000 claim is *unsecured*). His property interest in the automobile (which property interest has a value of $ 20,000) is constitutionally protected and must be preserved against depreciation during the proceeding if the debtor is to keep the car .Hence, the creditor will be entitled to receive periodic, usually monthly, payments *in cash* equivalent to the car's depreciation, which, let us assume, is determined upon a hearing by the court, to be $ 1,000 per month. An order will be

entered for the debtor to pay this amount to the creditor each month in reduction of the secured claim. Thus, at the end of the first month, the property value has fallen to $ 19,000, but the creditor has received $ 1,000, reducing his secured claim to $ 19,000. Thus, adequate protection payments equalize (or at least are supposed to equalize) the loss in value of the collateral. Let me emphasize that adequate protection payments bear no relation to the creditor's contractual monthly repayment terms, because contract rights, as oposed to rights in the debtor's property, may be suspended and modified in a reorganization (such modification, of course, is the principal purpose and effect of reorganization). Should the court find that adequate protection payments cannot equalize the loss in value threatened to the collateral during the course of the proceedings (for example, the debtor cannot pay or refuses to pay adequate protection payments which the court has already ordered it to pay; or the debtor has misused or abused the collateral), or should the court find that the collateral simply is not necessary for a reorganization, then, pursuant to § 362 Bankruptcy Code, the automatic stay may be lifted to permit the creditor to pursue his remedies for the enforcement of his secured claim.

Finally, let me note that questions of adequate protection or alternatively of obtaining return of property by lifting the stay are of greatest concern to debtor and secured creditors alike at the outset of the case, when these issues will usually be raised and litigated.

Other than for adequate protection, a secured creditor is not generally considered to be entitled to payments *during the course of the case* and is essentially forced to leave his capital with the debtor for the duration of the case with no recompense for the lost opportunity to reinvest it. At the conclusion of the case, however, a creditor who is oversecured, that is, the value of whose collateral is in excess of his total claim, will be entitled to recover post - petition[6] interest up to the total value of the collateral at

6) One principle of U.S. bankruptcy law, long held by the courts and codified in the 1978 statute, is that a creditor's claim in bankruptcy consists of principal and pre - bankruptcy interest. Post - bankruptcy interest is only paid if the estate is solvent.

that time; but a creditor whose claim is *undersecured* will receive no interest for the debtor's use of his collateral during the case. To illustrate :

Recall our creditor owed $ 25,000, who is secured by the $ 20,000 vehicle. He receives adequate protection payments to cover depreciation; but at the end of the case he is entitled to receive no more than the remaining principal balance of his secured claim. His collateral will not support an award to him of interest for the use of his money during the case.

On the other hand, let us assume, that a second creditor has a claim for $ 10,000, secured by a large machine worth $ 15,000 at the beginning of the case. This creditor is not entitled to adequate protection payments, as he has a cushion of $ 5,000 of excess value in the collateral over the amount of his claim. His claim will continue to accumulate post - petition interest, which he can realize out of this "cushion" at the conclusion of the case; but during the progress of the case, his payments are suspended. Note, however, that if his claim grows (by the accumulation of interest) or the value of the machine falls (by depreciation or as a result of market forces) during the case so that the claim is at some later point in time no longer fully secured by the value of the collateral, then adequate protection payments will be required from that point in time forward to protect this creditor's interest from loss of value[7].

An exception to this rule was created in § 506 (b) of the 1978 statute, which permits an award of post - bankruptcy interest to a secured creditor, the value of whose collateral is sufficient to permit the award of interest.

7) In the event that it is determined that a secured creditor has been injured as a result of the uncompensated decline in value of his collateral while it remained in the debtor's hands through the failure of the bankruptcy court to grant him adequate protection after he has requested it, the court may award the injured creditor an administrative expense claim under § 507 (b) to recompense the creditor for the loss in value of his collateral subsequent to the time he requested and was refused adequate protection.

Let us return to another essential aspect of reorganization: The debtor's opportunity to reject any contract upon which mutual performance remains due. The debtor can rid itself of burdensome cotnractual undertakings in this manner. The opportunity to reject these so-called "executory" contracts is an essential aspect of effective reorganization law, since it is often relationships of this nature which have substantially contributed to the debtor's problems. Such uneconomic responsibilities must be eliminated if debtor is once again to function as a viable enterprise. For example, the debtor may want to cancel long term sales contracts which have become unprofitable because the contract price is too low to cover current costs; conversely, it may need to abrogate long term requirements contracts in which the purchase price is higher than the current market. Further, the debtor may wish to terminate long term leases for facilities which the debtor plans to close in the scope of its reorganization, terminate employment agreements with non-union employees, and even reject tariff contracts governing the wages, hours and working conditions of its unionized employees, which agreements have been signed as a result of collective bargaining with its employees' unions. In all these cases but the last, which is subject to special rules[8], the debtor is essentially able to

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8) Union labor agreements present a special problem. The United States Supreme Court has recently held, in rejecting the reasoning of several lower courts that labor agreements cannot be rejected unless the debtor can affirmatively show that the union contract is so economically oppressive that a successful reorganization will not be possible unless the unionized employees' wages or working conditions are altered, that the same standard applies as in the rejection of any contract. This standard is simply that the rejection of the contract is in the debtor's best business interest. Congress just amended the Bankruptcy Code to impose by statute strict tests for rejection of union contracts similar to those formulated by the lower courts.

In the case of a rejection of a union contract, whatever standard applies, the debtor is still obliged to enter into collective bargaining with the employes' union for a new contract, and, of course, the employees' right to strike is not suspended in bankruptcy, even though their incentive to strike may be reduced when they are threatened with the collapse of their employer as a result of their strike.

cancel the contract at its discretion. The other party to the rejected contract is granted an *unsecured* claim against the debtor for breach of contract, which claim will be determined in amount by the bankruptcy court and be treated as a claim against the estate in the same manner as all other unsecured claims. What this means is that the debtor's rejection of the contract in bankruptcy acts essentially as if the debtor had breached the contract prior to bankruptcy. The aggrieved party obtains a breach of contract claim which will be treated under the reorganization plan exactly as if it were a pre-brankruptcy unsecured debt.

We have examined the opening of a reorganization case, as well as its effect on secured creditors and on the debtor's contractual relations. However, a reorganization case is only a vehicle to effectuate a long-term solution to the debtor's problems. That solution, including restructuring the debtor's capital, is proposed in a plan of reorganization. The debtor usually takes the initiative in proposing a plan, and in fact, the law guarantees the debtor a certain period of time, at least the first four months of the case, in wihch it can control the negotiations on the development of a plan and enjoy the exclusive right to obtain its approval by affected creditor and stockholder groups and by the court. In this plan, the rules for the treatment of the debtor's assets, the claims of its creditors, and any restructuring of the capital structure are set forth.

The provisions of law concerning what *may* be proposed in a plan are extremely generous. First, the plan may propose the sale of some of the debtor's assets, either its unprofitable parts to stop losses, or its profitable units to gain cash, to the extent such sales have not already been undertaken in the course of the case. The plan may even call for the sale of all of the debtor's assets to a successor, with the proceeds to be distributed to creditors according to priority rules.

In any event, the plan *must* provide for the treatment of *each* class of claims and stock interests. Speaking very generally, each secured claim (the claim of each mortgagee and each holder of a security interest in the debtor's personal property) forms a *separate* class and is treated individually; unsecured creditors form

a single class to be treated identically[9]; similarly, common stock and each preferred class of stock form separate classes of equity, all junior, of course, to all classes of creditors' claims.

There exist a few ground rules: (1) Each secured claim must be paid in full, since the security is available for satisfaction of the secured claim if liquidation of the debtor should occur. But the debtor has several options in respect of how each secured claim is satisfied: it can yield the collateral to the secured party and satisfy the claim in this maner; it can pay the claim in full upon the effective date of the plan, as is usually done when the debtor finds refinancing by a new lender in the course of the proceeding; or it can extend the secured creditor's contractual repayment terms, even over the creditor's objections, as long as the creditor is offered in the plan the full value of his secured claim as of the date the plan becomes effective. This last alternative means that the debtor must offer interest on the delayed payments to offset the delay in the creditor receiving his money. Of course, in this last option, the creditor retains his security interest, that is, his property rights in the security or in equivalent collateral, until he is paid in full.

(2) Unsecured creditors must be offered at least the liquidation value of their claims, after subtraction from the debtor's assets those pieces of property subject to security interests. This means that the minimum amount unsecured creditods may be offered in a plan is the amount that could be obtained by liquidating all assets not subject to security interests and mortgages. For example, if the value of assets not subject to liens is only 10 percent of the amount of unsecured claims, then the creditors are entitled by law to receive a minimum $0.10 on the dollar. But they must be, quite obviously, offered more than liquidation value as an incentive to obtain their support for the plan of reorganization.

Exectly what they may be offered in a plan, and in what form they will receive it, is a matter usually negotiated between the debtor and the official committee representing the unsecured cre-

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9) Trade creditors, i.e., suppliers of goods and services, almost always deliver on open credit in the United States; credit sales with a retained security interest are the exception.

ditors. It is this committee's job to insist on the highest pay-out feasible and consistent with the debtor's post - reorganization prospects for survival.

(3) If, as, already noted, the debtor cannot pay its creditors in full, that is, if it is insolvent, then its equity holders (stockholders) may not receive anything over the objection of the class of unsecured creditors. What may occur when a company is insolvent is that a restructuring of capital will be negotiated between the debtor and the committee representing the unsecured creditors, pursuant to which the unsecured creditors will receive a partial cash payment on their claims, either at once, or, more usually, in installment payments, over time, and then, in addition, receive shares of newly issued stock under which they, in effect, assume all or part ownership of the debtor[10]. At the same time the old stockholders' interest is effectively eliminated or reduced from a 100 percent ownership to a small fractional interest by the issuance of the new stock, often coupled with a cancellation of existing stock. As an example, the plan might call for the issuace, in a company with 10,000,000 shares outstanding, of 90,000,000 new shares to be distributed to unsecured creditors, along with some of cash payment, in full satisfaction of their unsecured claims. You will note that the portion of the unsecured debt not paid under the plan is *discharged* in order to afford the post - reorganization company a fresh start in business, Under the example, the stocholders of the old company would have their ownership reduced to 10 percent of the new company. Of course, the example is merely an illustration of one possible solution to paying off unsecured creditors under a plan.

If negotiations to formulate a plan, such as that suggested above, are successful, it is presented to the creditors and the stockholders for them to vote by classes. If each class accepts the plan

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10) Recall that the capitalization of debt as stock will normally occur only in cases of publicly held companies. In the case of small companies, the stockholders will usually retain their stock unaffected by the plan, and the plan will, in effect, constitute an offer to compromise the claims of unsecured creditors for a percentage, in cash, at once or over time, of their claims.

pursuant to voting requirements set forth in the statute ,the plan will be promulgated by the court, if it also meets all the statutory requirements set forth in § 1129. If the plan is rejected by a majority in one or more classes, it may still be promulgated by the court, under certain conditions, namely, that the objecting class receives no less than what it would receive upon the debtor's liquidation and, if the objecting class will not be paid in full, no class junior to the objecting class receives anything under the plan (this rule is called "cram - down"). The cram - down rule is based on the pervasive idea that you may not force anyone to accept less than his entire claim, unless no one junior in the priority system will receive anything at all in the proceedings.

If promulgated, the plan governs how the company will pay off its debts and deal with its stockholders; it has the force of law for all persons interested in the case.

A few final observations :

(1) Many reorganization attempts don't succed. Some fail because, despite the court protection granted the debtor in its efforts to restructure itself by retaining collateral as against its secured creditors and by rejecting contracts, no new financing can be obtained, or there simply isn't enough working capital to fund operations. Some fail because management isn't adequate and new management can't be found. Come fail because the parties can't agree on a plan of repayments which the debtor can afford. In these cases, liquidation follows.

(2) The reorganization depends for its success in substantial part on the effectiveness of the creditors' committee in representing and negotiating on behalf of the unsecured creditors, in insuring the debtor carries out its statutory duties and in obtaining the best possible realistic payment for the members of the unsecured class.

(3) The proceedings, as I have intimated in my comments, are carried out under the *adversarial system,* in which the parties present their positions on the facts and their requests for legal relief to the judge, who renders his decision based upon his findings of the facts as he determines them from the parties' presen-

tations. The judge does *not* independently investigate the facts, except to the extent that he may appoint an officer (called an examiner) to make an investigation and to present to the court an independent report on questions concerning the debtor's pre-bankrupcy conduct. Aside from this one instance however, the judge decides questions of fact essentially upon the information presented by the parties.

I have offered you a very brief introduction to the law governing U.S. reorganization proceedings, which is the culmination of a 50 year effort to develop a fair and effective way to deal with problems of failing businesses outside of the political arena. As I noted at the outset, the American goal is to preserve the economic viability of the enterprise without shifting the losses away from those who must be assumed to have accepted the risk of business loss - in the first instance, the stockholders, who may be wiped out in a successful reorganization, and in the second instance, the trade and other unsecured creditors.

Nevertheless, by preserving going concern value and avoiding piecemeal liquidation, jobs are saved in most circumstances, and value is preserved for the unsecured creditors, even if not for the stockholders, value which is usually destroyed in liquidation.