Forum for Asian Insolvency Reform
INSOLVENCY REFORM IN ASIA:
AN ASSESSMENT OF THE RECENT DEVELOPMENTS AND THE ROLE OF JUDICIARY
Bali - Indonesia, 7-8 February 2001

THE ROLE OF THE COURT IN PREPACKAGED AND PRENEGOTIATED PLANS IN THE UNITED STATES

Prepared by
Mr. Richard Broude,
Law Offices of Richard F. Broude
New York, United States of America

I

INTRODUCTION

Many reorganizations of businesses in financial distress occur outside of the court system. This is as true of large companies as of small. If the circumstances of the debtor are such that it can obtain the relief it seeks without the necessity for a formal court proceeding under Chapter 11 of the United States Bankruptcy Code, an out-of-court process is a much less dislocating and upsetting experience. It is generally more expeditious and considerably less expensive. If, for example, the company is current on its trade debt, payroll and the like, and is only having problems with its bank revolver, nothing more than a waiver of covenants or a moratorium may be needed. If the problem is with a series of debentures that is not widely held, relief may be obtained by renegotiating the terms of the debt.

The principal failing of the out-of-court procedure, however, is that creditors who do not agree to the revised deal (generally called "dissenters" or "dissenting creditors") cannot be bound by the will of the majority, no matter the level of acceptance. If one creditor out of 25 or 100 or 1000 disagrees and all the other creditors agree, no matter. That one dissenting creditor is free to pursue its remedies to collect its debt. While the other creditors or the debtor may buy out the dissenter, that only infrequently happens; the precedent is not a happy one. More is needed to bring the deal together and to make it binding on the dissenters. That "more" has come to be known as the "prepackaged" or "prenegotiated" plan, because only in bankruptcy can dissenters be bound.

II

WHEN PREPACKAGING IS AN ALTERNATIVE

Before discussing those alternatives, we should first explore the situations in which a full bankruptcy proceeding is not needed and prepackaging or prenegotiating is a viable alternative. The archetypical examples, and the genesis for the type of procedure we are going to discuss, were companies that, in the 1980's, were involved in leveraged buyouts. These companies needed to restructure the right side of their balance sheets rather than the left side. That is, they had sound, successful business operations but were overleveraged and unable to deal with the level of debt that had resulted from the LBO. These companies were current in the payment of trade and other short-term debt, and may not have been in default on their bank lines of credit, but had problems with the holders of one or more issues of medium or long-term debt, known not infrequently as "junk bonds". These bonds usually

Copyright © OECD 2001 All rights

carried high rates of interest, were generally subordinated to other types of claims, and contained restrictive covenants and conditions with which the debtor was simply unable to cope. Such companies did not need a full-blown chapter 11 case; they just had to make a deal with the bondholders.

The full panoply of debtor protections, rights and remedies furnished to chapter 11 debtors, such as the automatic stay of creditor action, the ability to reject onerous executory contracts and leases, and the ability to restructure secured debt is basically meaningless to the debtor we are describing. Unless the bondholders have taken action that threatens to destabilize the debtor and its business operations, such as by filing a lawsuit and seeking to attach assets of the debtor pre-judgment), a chapter 11 is of little utility.

In such a situation, the prepackaged plan has been advanced as a device that solves all (or at least most) problems. If a default is threatened or has occurred on one or more issues of bonds, the holders will generally appoint a committee to represent all the bondholders in negotiations with the debtor. If there is an agreement to restructure the debt (which may involve new bonds being issued in exchange for the old bonds and, in addition, provide for the bondholders to receive some form of equity security of the debtor), an exchange offer can be made under applicable Federal and State securities laws. These laws generally require, at least where the debt is publically held, that an informational document, usually a prospectus, be sent to each holder of the debt instrument that is being exchanged. Because dissenters cannot be bound, these exchange offers require an artificially high acceptance rate (e.g., 90 to 95% of all the bonds subject to the offer), a percentage not frequently obtained. The prospectus goes out, the votes come in, and the parties must then decide how to proceed.

III

PLAN CONFIRMATION IN THE ORDINARY CASE

At this point, it is worth a detour to describe briefly the process of negotiating and confirming a plan of reorganization in a typical chapter 11 case. The debtor has business operational problems and a plenary (that is, full-blown) chapter 11 case was necessary. Once the debtor has gotten through the early stages of a case, operations have been stabilized, and whatever remedial action needed to turn around the business has been taken, the parties in interest begin to discuss the terms of a plan of reorganization. The plan is the contract that will restructure the debtor’s debt and set forth the terms under which that debt will be paid. The principal negotiators are the debtor, one or more committees of creditors appointed at the commencement of the case to represent holders of the types of debt held by members of each committee, and sometimes a committee of equity security holders. Negotiations must also be held with important secured creditors.

In larger cases, it is not uncommon for the plan to reduce the amount of debt that the company has to pay, provide for the repayment of that debt over a period of time, and transfer most if not all of the equity of the company from the previous stockholders to the creditors.

Once the parties have agreed to the terms of a plan, the plan, along with a disclosure statement is filed with the bankruptcy court. The disclosure statement is an informational document that, when approved by the court, will be distributed to creditors being called upon to vote for or against the plan. The Bankruptcy Code requires that the disclosure statement must contain “adequate information”, defined as

Copyright © OECD 2001 All rights

"information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature of history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor typical of holder and claims or interests of the relevant class to make an informed judgment about the plan . . .."[1]

---

[1] Bankruptcy Code § 1125(a).

Copyright © OECD 2001 All rights

The bankruptcy judge must approve the disclosure statement following a notice and hearing. Once approval has been obtained, the plan, the disclosure statement, a ballot, and a notice of the time and place of the hearing on confirmation of the plan are mailed to creditors who will vote on the plan. (Creditors in classes whose rights and remedies are not affected by the plan do not vote.) Until this mailing occurs, votes for or against the plan cannot be solicited. If a plan is to be confirmed consensually,[2] each class that votes must accept the plan by the requisite majorities–in the case of classes of creditors, by a majority in number and two-thirds in amount of those creditors in each class that actually vote. A class of equity security holders accepts a plan if at least two-thirds in amount of voting members of the class accept the plan.

Once the vote is in, a confirmation hearing is held by the bankruptcy judge. The debtor[3] must satisfy the court that the so-called confirmation standards, thirteen in all, have been satisfied.[4] The two most important of these standards are called "best interests of creditors" and "feasibility". The former is designed to protect the minority against the majority by providing that each creditor in a consenting class must receive under the plan at least as much as that creditor would receive if the debtor were liquidated in a chapter 7 case under the Code.[5] That is, the "best interests" standard sets a floor on the deal that the committee representing those creditors can make. The debtor will present evidence at the confirmation hearing from expert witnesses and others regarding what creditors might expect to receive if the debtor were liquidated.

---

[2] The alternative, a non-consensual plan confirmed under the so-called "cramdown" powers, will not be discussed here.

[3] Actually, a plan can be filed by third parties in certain circumstances, but that possibility will not be discussed here.

[4] These standards are found in § 1129(a) of the Code.

[5] Code § 1129(a)(7).

Copyright © OECD 2001 All rights

The "feasibility test" states that the court must be satisfied that confirmation of the plan "is not likely to be followed by the liquidation, or the need for further financial reorganization of the debtor or any successor to the debtor . . .."[6] It is the role of the court here, following expert testimony as to the future earnings of the debtor and its ability to perform under the plan, to determine that the debtor will "make it" in the business world once it has emerged from the protection of the bankruptcy court. The larger the case, the more sophisticated the testimony, which will frequently be proffered by investment bankers who will present detailed projections of the results of the debtor's business operations over the next three to five years or so.

One frequently-voiced objection to the confirmation process is that many if not all bankruptcy judges are not equipped to evaluate this testimony. Because all the parties in interest have agreed to the deal, there frequently are no objections to confirmation and consequently no cross-examination of the debtor's witnesses on the feasibility issue. Projections may be overly optimistic and the parties' desire to get out of chapter 11 as promptly as possible may lead, in turn, to testimony about the debtor's future that is unrealistic.

IV

PLAN CONFIRMATION IN PREPACKAGED CASES

The Bankruptcy Code and Bankruptcy Rules contain provisions making a prepackaged plan possible. Section 1126(b) provides that votes solicited before a chapter 11 case has been commenced may be counted toward confirmation of that plan if "the solicitation . . . was in compliance with any applicable nonbankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation". The "nonbankruptcy law" most frequently applicable in prepackaged plans are the various Federal (and sometimes State) securities acts.

In the typical case that we have been discussing, we will assume that the exchange offer sent to bondholders has complied with applicable securities laws. The votes have come in, and they satisfy the relevant acceptance criteria of the Code (a majority in number and two-thirds in amount of those voting) but are less than the 95% supermajority sometimes demanded. The prospectus has stated that the votes being solicited could, if necessary, be used in chapter 11 case, so no one is surprised when the debtor files chapter 11 to bind the dissenting creditors.

The plan itself does little but change the rights of the bondholders whose bonds caused the problems being dealt with by the plan. Trade creditors are left alone and do not vote. Most of the time, secured debt likewise is unimpaired and need not vote.[7]

The bankruptcy filing is thus accompanied by the plan, the prospectus (which takes the place of a disclosure statement), and the ballots. The debtor requests an early setting of a hearing to confirm the plan. At the

---

[6] Code § 1129(a)(11).

[7] The technical term for these classes of creditors whose rights and remedies are not being affected by the plan is that the class is "unimpaired". Classes of creditors whose claims are unimpaired do not vote upon a plan of reorganization. Code §§ 1124, 1126(f).

Copyright © OECD 2001 All rights

hearing, the court will be requested to find that the pre-filing solicitation of votes complied with section 1126(b)[8] and will be asked to confirm the plan. Even in a prepackaged situation, the confirmation standards must still be satisfied, and testimony is still necessary. However, in cases concerning prepackaged plans, the testimony is even less open to examination by another party in interest than in the plenary chapter 11 situation, and the bankruptcy judge less equipped to evaluate its credibility.[9]

The length of time between filing of the case and confirmation of the plan can be very short–30 days is not unheard of. Whether this is a good thing or not is another matter altogether.

V

THE ROLE OF THE JUDGE IN THE CONFIRMATION PROCESS

As earlier noted, the larger the case the less the bankruptcy judge is equipped to evaluate the testimony offered to satisfy the confirmation standards. The situation is exacerbated when a prepackaged plan is involved. And yet the Code relies upon the judge as the "gatekeeper"; that is, the individual whose approval is needed before the debtor can emerge from chapter 11. There is some evidence that the less oversight exercised over the case by the judge, the more likely it is that the reorganized debtor will find itself back in bankruptcy.

For reasons beyond the scope of this paper, most chapter 11 cases of any size are filed in the bankruptcy court in the State of Delaware, the state in which many American corporations are incorporated. Almost all cases involving prepackaged plans are filed there.

---

[8] Bankruptcy Rule 3018(b) gives some specific content to the more general requirement of section 1126(b).

[9] A pre-negotiated plan differs somewhat from a prepackaged plan. In the former, the parties have agreed to the terms of a plan but no pre-filing votes have been solicited. More than one class may be impaired. The petition is filed, the court holds a prompt hearing on the disclosure statement which, once approved, opens the door to vote solicitation and a quick confirmation hearing.

Copyright © OECD 2001 All rights

The Delaware bankruptcy court is commonly perceived to be more debtor-friendly than any other bankruptcy court in the country. It turns out that there is a price to be paid for such an attitude. In an article shortly to be published that focuses on bankruptcy cases involving publically-held corporations,[10] the authors conclude that the "refiling rate [in Delaware] is six to seven times as high as the refiling rate for companies reorganizing in all other U.S. bankruptcy Courts."[11] Half of the filings in Delaware studied involved prepackaged cases.

[10] Lynn M. LoPucki & Sara D. Kalin, "The Failure of Public Company Bankruptcies in Delaware and New York: Empirical Evidence of a 'Race to the Bottom'", ___ Vanderbilt L. Rev. ____ (2001).

[11] *Id.* at ___.

Copyright © OECD 2001 All rights

The authors conclude that the refiling rate in Delaware is a consequence of the competition among courts for the biggest cases–"Competing courts attract filings by applying lax standards for plan confirmation that lead to the excessive refiling rates,"[12] and "a part of Delaware's appeal was its willingness to confirm no-questions-asked reorganizations."[13]

What all of this seems to prove is that the judge's role in the confirmation process is vital–the confirmation standards are meant to be taken seriously and the judge is to determine whether the evidence has satisfied the debtor's burden in showing that the standards have been satisfied. Congress, however, has furnished the judiciary with almost none of the tools necessary to do the job. Bankruptcy judges do not employ experts to evaluate the testimony given at the confirmation hearing, and do not have lawyers and other professionals who could do so.

The situation is worse in the case of prepackaged plans. The speed with which such cases are processed precludes any evaluation at all because the judge does not have the benefit of having had the debtor in its court over the two to five year period it generally takes to confirm a plenary chapter 11 case of any size. Further, the LoPucki-Kalin article suggests that some judges are co-conspirators in the process of confirming plans that are doomed to fail.

VI

CONCLUSION

It was the purpose of this paper to explore the relationship between the court and the parties in situations involving prepackaged plans. The conclusion is clear: whether because of the system, or because of judicial attitudes, there is almost no relationship, and the system suffers for it.

[12] *Id.* at ___.

[13] *Id.* at ___.

Copyright © OECD 2001 All rights