

I N S I D E   T H E   M I N D S

# Creditors' Rights in Chapter 11 Cases

*Leading Lawyers on Navigating the Reorganization  
Process, Exercising Creditors' Rights, and  
Understanding the Impact of Current Developments*



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# Exercising Your Rights and Understanding Your Goals

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I primarily represent banks, financial institutions, and insurance companies as creditors in bankruptcy cases and out of court workouts and restructurings. I believe that the value I offer to my clients is to formulate and implement a strategy that is tailored to the facts and circumstances of each case, based upon my broad-based experience over more than twenty-five years dealing with creditor's rights issues on a national basis. In the last eighteen months, I have seen a significant increase in the number of loan workouts and bankruptcy cases. During this period, most of the bankruptcy cases in which I have been involved relate to the manufacturing, subprime mortgage, and retail industries.

### **Creditor's Rights Prior to a Bankruptcy Case**

#### *Recognizing Warning Signs Indicating That a Debtor is Financially Troubled*

A creditor can best protect its rights by addressing issues with a financially troubled debtor as soon as possible. Consequently, prior to the filing of a bankruptcy case, it is critical for a creditor to be attentive to signs of a potential financial problem. These signs include:

1. Inability to meet financial projections
2. New loans to pay trade debt
3. Inability or refusal to provide current financial reports
4. Reduction in sales or revenue
5. Lawsuits
6. Failure to return telephone calls or discourages on-site visits
7. Failure to pay taxes or other debts
8. Failure to comply with covenants set forth in loan agreement

#### *Evaluate the Creditor's Claims*

When representing a creditor prior to a bankruptcy filing, the first task is to evaluate the nature and extent of the creditor's claims. This process includes determining whether there are any deficiencies in the documentation, such as whether the documents are properly executed, financing statements and mortgages are properly recorded, and the documents recite the correct names (including trade names) of the parties. In addition, for a secured

creditor, I analyze the ability of the creditor to realize on its collateral. The perfection of the creditor's liens, the value of the creditor's collateral (which may include obtaining an appraisal), and the availability of additional collateral must be assessed.

### *Remedies for Debtor's Default*

If the debtor defaults under the applicable documentation, the creditor should consider taking action to enforce its rights. These rights include:

1. Default Notice. Upon a debtor's failure to make payment or otherwise comply with the applicable documents, a creditor may issue a notice in accordance with the documents declaring the debtor in default.
2. Setoff. If permitted under the documents or applicable law, a creditor may set off all amounts owing by the creditor to the debtor against amounts owing by the debtor to the creditor.
3. Termination. A creditor should consider whether cause exists to terminate its contractual relationship with the debtor.
4. Guarantors. If the debtor's obligations have been guaranteed, a creditor should notify the guarantor of the default and may commence suit against the guarantor to collect on the guaranty.
5. Reclamation. If a debtor has received goods on credit while insolvent, the creditor should determine whether it has the right to reclaim the goods under Section 2-702 of Uniform Commercial Code.

If the creditor is a lender under a credit facility, the lender should consider taking additional action:

- A. Terminate Loan Commitment. Upon the occurrence of an event of default, the lender may issue a notice to the borrower in accordance with the loan documents terminating the commitment to lend money to the borrower.

- B. Accelerate Indebtedness. The lender may notify the borrower that all indebtedness owing by the borrower is accelerated and immediately due and payable.
- C. Default Interest Rate. The lender may notify the borrower that the indebtedness owing by borrower is accruing interest at the default rate.
- D. Terminate Borrower's Right to Collect Payments. Loan documents usually provide that the borrower may collect all receivables and use such collections to carry on its business. However, upon default, a creditor may instruct the borrower that all collections be immediately endorsed and delivered to the creditor. A creditor may also instruct all customers and account debtors to remit all payments directly to the creditor.
- E. Foreclosure. The lender may commence a foreclosure with respect to its collateral in accordance with Article 9 of the Uniform Commercial Code applicable state law. A foreclosure under Article 9 of the Uniform Commercial Code is generally an expedient process. However, the lender needs to have possession of its collateral. If the lender does not have possession, it will need to file a lawsuit to gain possession.
- F. Receivership. The lender may commence an action under applicable federal or state law seeking the appointment of a receiver to take possession of the lender's collateral.

### *Risk Avoidance*

A lender that exercises undue control over its borrower is exposed to the risk of a lender liability claim. See e.g., *In re Giampietro*, 317 B.R. 841, 848-849 (Bankr. Nev. 2004); *McCleary Cattle Co. v. Sewell*, 73 Nev. 279 (1957). Discussions between a lender and a borrower experiencing financial difficulties have often been the source of lender liability claims based upon

a borrower's allegations that the lender agreed to provide some financial accommodation, such as extending the maturity date, advancing additional loans, or waiving a default.

1. Credit Agreements Act. Many states, however, have protected lenders from certain lender liability claims by prohibiting causes of action based upon oral agreements. For example, the Illinois Credit Agreements Act, 815 ILCS 160/0.01 *et seq.*, provides that a borrower may not maintain an action on, or in any way related to, a credit agreement unless the credit agreement (i) is in writing, (ii) expresses an agreement or a commitment to lend money or extend credit or delay or forbear repayment of money, (iii) sets forth the relevant terms and conditions, and (iv) is signed by the lender and the borrower. *Klem v. First National Bank of Chicago*, 655 N.E.2d 1211 (Ill. App. 2d Dist. 1995). This protection is also afforded to other agreements, such as guaranties, which are related to a credit agreement. See e.g., *FINOVA Capital Corp. v. Slyman*, 2002 WL 318294 (N.D. Ill. February 21, 2002). See also MN ST §513.33.
2. Ground Rules Letters. One way to avoid misunderstandings (whether real or contrived) is to execute an agreement that identifies the terms under which the parties will negotiate a workout.
3. Establishing a Paper Trail. Even if a ground rules letter is not utilized, it is helpful to document in writing your discussions. Remember to keep all communications professional and businesslike.

### **Creditor's Rights under the Bankruptcy Laws**

Once a bankruptcy case is commenced, the creditor's rights under the bankruptcy laws depend initially on whether the creditor's claim is secured or unsecured. If the creditor is secured, its rights are further affected by the nature and extent of its collateral. An unsecured creditor's rights are generally close to the bottom of the priority scheme.

*Basic Elements of a Chapter 11 Filing*

1. Definition of a Claim. The term “claim” is defined broadly under the Bankruptcy Code to mean essentially any right to payment from the debtor that exists as of the date that the bankruptcy petition is filed. 11 U.S.C. § 101(5). Accordingly, claims can include debts that are contingent or unliquidated. Whether a claim is valid and enforceable is determined based upon state law or non-bankruptcy federal law.
2. Determination of Secured Claims. Similarly, the determination of whether a creditor holds a valid and perfected security interest in any of the assets of the debtor is determined based upon applicable state law, not bankruptcy law. *Butner v. U.S.*, 440 U.S. 48, 54 (1979); *In re Martin Grinding and Machine Works Inc.*, 793 F.2d 592, 594 (7<sup>th</sup> Cir. 1986). Section 506 of the Bankruptcy Code provides that a creditor that holds a valid and enforceability security interest on assets of the debtor is secured only to the extent to the value of its collateral. In other words, a creditor may assert a secured claim only to the value of its collateral and may assert an unsecured claim to the extent that its claim exceeds the value of its collateral. Thus, if it is determined that as of the date of bankruptcy the secured creditor’s collateral is worth \$8 million on a loan with a current balance of \$10 million, the creditor has a secured claim for \$8 million and an unsecured claim for \$2 million. The creditor is entitled to this unsecured claim under Bankruptcy Code even if its loan documents are nonrecourse.
3. Valuation of Creditor’s Security Interest. Under Section 506 of the Bankruptcy Code, in a Chapter 11 case, a creditor’s security interest in its collateral is to be valued “in light of the purpose of the valuation and the proposed disposition or use of such property....” Accordingly, if a debtor’s plan proposes to liquidate a creditor’s collateral, a

liquidation value would be appropriate. On the other hand, if the debtor's plan proposes to retain the use of the creditor's collateral, a fair market valuation is appropriate. Where a creditor's collateral is significant, the Bankruptcy Court usually determines the valuation after receiving appraisal testimony on behalf of both the creditor and the debtor. These experts typically employ recognized methods of valuation in order to arrive at their opinion as to value. For example, the valuation of an ongoing business is often determined by projecting the future earnings of the business and then discounting those earnings to present value.

Despite these general principles, courts have disagreed on how to value a creditor's collateral for bankruptcy purposes. However, in 1997, the United States Supreme Court in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997) (Associates Commercial), established a favorable methodology for valuing a creditor's allowed secured claim under the Bankruptcy Code. As mentioned above, pursuant to Section 506(a) of the Bankruptcy Code, an allowed claim of a secured creditor can be stripped down to the value of the creditor's collateral, with the creditor receiving an unsecured claim for the loan balance in excess of the collateral value. The Supreme Court in *Associates Commercial* held that collateral retained by a bankruptcy debtor must be valued at its replacement value, rather than at the lower liquidation value. Indeed, *Associates Commercial* defined replacement value to be fair market value. The Supreme Court stated that replacement value "is the price a willing buyer in the debtor's trade, business, or situation would pay to obtain like property from a willing seller." In selecting the higher valuation methodology, the Supreme Court noted that a debtor that continues to hold and use a creditor's collateral exposes the creditor to a double risk: the debtor may default again and the collateral may deteriorate in value from continued use. These risks, according to the Court, are not fully

offset by adjustments in the interest rate or demands for more adequate protection.

Associates Commercial involved a Chapter 13 debtor who attempted to retain a secured creditor's collateral and crammed down the outstanding loan balance to the liquidation value of the collateral. The Supreme Court reversed the Fifth Circuit Court of Appeals, which permitted the use of the liquidation value for cram down purposes. The Court also rejected the approach taken by the Seventh Circuit in *In re Hoskins*, 102 F.3d 311 (7th Cir. 1996), which valued the debtor's property based upon an average between liquidation value and replacement value.

Although citing Chapter 11 cases in support of its analysis, the Supreme Court carefully referenced its holding as being in the context of a Chapter 13 case. Nevertheless, the Associates Commercial ruling logically should affect all cases under the Bankruptcy Code, since Section 506(a) and the computation of a creditor's allowed secured claim applies to all chapters of the Bankruptcy Code. The courts, however, have been split on this issue.

4. Automatic Stay. The automatic stay is an injunction issued automatically on the filing of the bankruptcy case. 11 U.S.C. §362(a). The automatic stay enjoins all creditors from, among other things, attempting to recover a pre-petition claim against the debtor, to enforce a lien against property of the debtor's estate, to obtain possession of property of the debtor's estate, and to take other adverse action against the debtor.
  
5. Relief from the Automatic Stay. A secured creditor may seek relief from the automatic stay in order to pursue its state law foreclosure rights. Under §362(d) of the Bankruptcy Code, there are two primary standards for modifying the automatic stay. The first is for cause, including a lack of adequate protection. See discussion of

adequate protection below. The second is if (i) the debtor does not have any equity in the property and (ii) the property is not needed for an effective reorganization. With respect to the first standard—a lack of adequate protection—a debtor will often try to argue that the value of the collateral exceeds the amount of the secured creditor's claim, and therefore, the secured creditor is adequately protected by the equity cushion in its collateral. In this analysis, junior lien claims are not considered when determining whether an equity cushion exists. Where there is little or no equity in the collateral, the bankruptcy courts have generally held that the collateral itself is not sufficient to adequately protect the interest of the secured creditor. Obviously, the difficulty is in determining what amount of equity cushion is sufficient. In this regard, the bankruptcy courts take into consideration many factors, including:

- (i) Whether the collateral is appreciating, depreciating or staying the same
- (ii) The amount of debt accruing against the collateral
- (iii) The amount of equity available

For example, if the fair market value of the secured creditor's collateral were \$6 million and if the debts secured by the collateral exceeded \$8.9 million, the debtor would have no equity in the collateral, and the burden of proof would shift to the debtor to establish that the collateral is needed for an effective reorganization. The debtor may attempt to assert that the collateral is necessary for any effective reorganization because without the collateral, the debtor has no business to reorganize. However, the test is whether the debtor can show that it has a reasonable possibility of achieving a successful reorganization in a reasonable period of time. *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assoc. Ltd.*, 484 U.S. 365 (1988).

6. Cash Collateral and Adequate Protection. Another benefit received by a debtor under the Bankruptcy Code is that the debtor is permitted to use all of its assets, including the collateral of the secured lender, in the ordinary course of business even though a secured lender is stayed from collecting its debt or enforcing its rights and remedies. 11 U.S.C. § 363(c)(1). In a multi-asset case, these provisions of the Bankruptcy Code generally preserve the debtor's assets as a group, which allows the debtor to maintain jobs for its employees and to enhance the value of its assets, since assets are generally worth more as part of a going concern.

The Bankruptcy Code, however, provides an exception to this general rule for “cash collateral.” Cash collateral is defined under the Bankruptcy Code as cash or cash equivalents “in which the estate and an entity other than the estate have an interest and includes the proceeds, products, offspring, rents or profits of property subject to a security interest ...” 11 U.S.C. §363(a).

The Bankruptcy Code provides that a debtor may not use, sell, or lease cash collateral unless:

- (i) Each entity that has an interest in such cash collateral consents; or
- (ii) The bankruptcy court, after notice and hearing, authorizes such use, sale or lease in accordance with the applicable provisions of the Bankruptcy Code. 11 U.S.C. §363(c)(2).

Consequently, immediately after a bankruptcy case is filed, a creditor should send a letter to counsel for the debtor stating that the creditor does not consent to the debtor's use of the creditor's cash collateral.

Pursuant to Section 363(e) of the Bankruptcy Code, a party that has an interest in cash collateral is entitled to

adequate protection for the debtor's use of such cash collateral. When construing this concept of adequate protection, bankruptcy courts have generally held that adequate protection is intended to protect a secured creditor from a decrease in the value of its collateral.

Accordingly, a secured creditor's right to adequate protection is limited to the lesser of the amount of its claim or the value of its collateral as of the day of the filing of the bankruptcy petition. Conversely, where the debt exceeds the fair market value of the collateral, the secured lender is entitled to adequate protection only for the value of the collateral.

If collateral has no value (i.e., creditor is totally unsecured), creditor is not entitled to any adequate protection. This concept coincides with Section 506(a) of the Bankruptcy Code, which provides that a claim is secured only to the extent of the value of its collateral and unsecured to the extent of the excess of the claim over the value of the collateral. If the property subsequently appreciates, the secured creditor may not receive the benefit of this appreciation.

In addition, the secured creditor is generally not entitled to receive or accrue interest and other charges post-bankruptcy. 11 U.S.C. §502(b)(2). The only exception to this rule is for over-secured creditors that are allowed to continue to accrue interest post-bankruptcy. 11 U.S.C. §506(b).

7. Executory Contracts. Section 365(a) of the Bankruptcy Code allows a debtor to assume or reject any pre-petition unexpired lease or "executory contract," subject to the Bankruptcy Court's approval and certain enumerated exceptions. Congress, however, did not define the term "executory contract" in the Bankruptcy Code, choosing instead to leave the term to judicial interpretation. Most

courts have settled on a definition of an executory contract as one “under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other.” See *In re Cardinal Industries Inc.*, 146 B.R. 720, 727 (Bankr. S.D. Ohio 1992).

If a debtor wishes to assume a beneficial executory contract, it must cure all defaults thereunder and provide adequate assurance for its future performance under that contract. 11 U.S.C. §365(b). If the debtor elects to reject an executory contract, the other party to the contract is entitled to a pre-bankruptcy unsecured claim for the damages caused by the rejection (this is a relatively low priority in the scheme of distribution). 11 U.S.C. §502(g). In order to assume or reject an executory contract, the debtor must deal with the agreement as a whole, rather than assuming only the beneficial aspects and rejecting the burdensome ones. *In re UAL Corp.*, 346 B.R. 456, 467 (Bankr. N.D. Ill. 2006). However, if a single document contains separate, severable agreements, the debtor may reject one agreement and assume the other. *Stuart Title Guar. Co. v. Old Republic National Title Ins. Co.*, 83 F.3d 735, 741 (5<sup>th</sup> Cir. 1996).

Before an executory contract is assumed or rejected under Section 365(a) of the Bankruptcy Code, the contract is enforceable by the debtor-in-possession, but is not enforceable against the debtor-in-possession by the non-debtor party to the contract. See e.g., *In re National Steel Corp.*, 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004); *In re Continental Energy Assoc. Ltd. Partnership*, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995). However, if the debtor-in-possession continues to receive benefits under the contract pending a decision to assume or reject the contract, the debtor-in-possession is obligated to pay for the reasonable value of those services, which may be what is specified in

the contract. *NLRB v. Bildisco & Bildisco*, 465 U.S. 513, 531 (1984).

A debtor, however, cannot assume or reject an unexpired lease or executory contract which was terminated in accordance with its terms prior to a bankruptcy petition and such contract cannot be revived post-bankruptcy. See e.g., *In re Island Helicopters*, 211 B.R. 453, 464 (Bankr. E.D. N.Y. 1997); *In re Comp III Inc.*, 136 B.R. 636, 639 (Bankr. S.D. N.Y. 1992). (Termination of franchise agreement by franchisor one day before bankruptcy filing after franchisee gave notice of its intent to file for bankruptcy on the following day will be effective, and franchise agreement can not be reinstated post-bankruptcy, where termination was in accordance with the terms of the franchise agreement.) In addition, a pre-bankruptcy notice stating that a contract is terminated as of a particular date will validly terminate the contract, even when the effective date occurs post-petition, if the debtor has no post-petition cure rights, because the automatic stay does not toll the simple passage of time. *Moody v. Amoco Oil Co.*, 734 F.2d 1200, 1213 (7<sup>th</sup> Cir. 1984). See also, *In re Personal Communications Network Inc.*, 249 B.R. 233 (Bankr. E.D. N.Y. 2000) (pre-petition termination of FCC license was effective when grace period expired prior to bankruptcy filing).

The giving of a notice of termination post-petition constitutes a post-petition act, but it does not readily fit within the conduct prohibited by the automatic stay. However, as previously mentioned, the automatic stay prohibits any act to obtain possession of, or exercise control over, property of the debtor's estate. Many courts have concluded that this provision applies to attempts to terminate executory contracts even where the debtor's property interest consists solely of contractual rights or other intangible property, such as a trademark. See e.g., *Computer Communications Inc. v. Codex Corp.*, 824 F.2d 725,

728-730 (9<sup>th</sup> Cir. 1987); *In re Tudor Motor Lodge Assoc. Ltd. Partnership*, 102 B.R. 936 (Bankr. D.N.J. 1989).

An exception to the general rule that a debtor must cure all defaults in order to assume an executory contract is that the debtor is not required to cure defaults triggered by the debtor's financial condition or the bankruptcy case itself. 11 U.S.C. §365(b)(2). In addition, Section 365(e)(1) provides that notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, an executory contract or unexpired lease of the debtor may not be terminated or modified at any time after the commencement of the bankruptcy case solely because of a provision in such contract or lease that is conditioned upon (i) the insolvency or financial condition of the debtor, (ii) the commencement of a bankruptcy case, or (iii) the appointment of a bankruptcy trustee or custodian for the debtor's assets. Accordingly, provisions of an executory contract or an unexpired lease which provide for the automatic termination of the contract or lease based upon the enumerated conditions are referred to as ipso facto clauses and are not enforceable post-bankruptcy. See e.g., *In re Joshua Slocum Ltd.*, 922 F.2d 1081, 1090 (3<sup>rd</sup> Cir. 1990).

### *Evaluating a Creditor's Rights in a Bankruptcy Case*

A creditor in a bankruptcy case also needs to protect its rights by addressing issues with the debtor promptly. Once again, this process starts with a review of the applicable documentation and determining if it contains any weaknesses.

If the creditor is secured, I conduct lien searches to assess whether any collateral the creditor holds is properly perfected or if there are competing claims to that same collateral. I also assess whether there is any possibility of improving the creditor's position by obtaining additional collateral, guarantees, or other rights. This is followed by assessing whether the

creditor should protect its rights by taking any sort of action. Such action might include seeking adequate protection or relief from the automatic stay.

It is also necessary to determine whether it is helpful for the creditor to obtain any other professional assistance, such as appraisers or financial consultants who might be able to provide additional insight on the situation or the value of the collateral. These experts can help assess the nature, extent, and value of the creditor's rights.

### *Steps to Exercise Creditor Rights*

While the evaluation procedure is generally the same, the steps that a creditor may take are adjusted to the unique facts and circumstances of each case. For example, if the creditor is a licensor of intellectual property one of the rights that creditor may be able to exercise is terminating the license agreement. That is potentially a very important step because, as stated above, a pre-bankruptcy termination is enforceable post-bankruptcy. Therefore, if the licensor were to terminate the debtor's rights under that license agreement on January 1 and the debtor filed bankruptcy on January 15, that pre-bankruptcy termination would be enforceable, and that termination may give the licensor significant leverage when dealing with the debtor in the subsequent bankruptcy. If the licensor does not terminate on January 1 and the debtor files on January 15, the automatic stay prevents the licensor from terminating without prior approval from the Bankruptcy Court. A creditor is generally in a much better position if it exercises its rights prior to bankruptcy rather than attempting to do so after bankruptcy.

### *The Reorganization Process*

One of the primary goals of the Bankruptcy Code and Chapter 11 in particular, is to provide a debtor with a breathing spell during which it can reorganize in an orderly manner in order to operate successfully in the future. *U.S. v. Whiting Pools*, 462 U.S. 198, 203 (1983). Under Chapter 11, a debtor has the exclusive right to prepare and file a plan of reorganization. A plan is generally a framework by which the debtor classifies the claims of creditors and proposes a certain treatment or payment for each class of creditors. In order for that plan to be approved by the Bankruptcy Court,

the debtor has to satisfy sixteen conditions that are set forth in Section 1129(a) of the Bankruptcy Code.

One of the more important conditions for confirmation under Section 1129(a) of the Bankruptcy Code is feasibility. The debtor must establish that its plan is feasible based upon concrete and reliable data. See e.g., *In re Ritz-Carlton of D.C. Inc.*, 98 B.R. 170, 172 (S.D.N.Y. 1989). While the debtor “does not need to establish that the plan carries a guarantee of success,” the debtor must nevertheless “show that it provides for a reasonable assurance of commercial viability.” *In re Repurchase Corp.*, 332 B.R. 336, 342 (Bankr. N.D. Ill. 2005). Some of the factors that the bankruptcy court will consider in determining whether a plan is feasible include: (a) adequacy of the debtor’s capital structure, (b) earnings power of the business, (c) economic conditions, (d) ability of the debtor’s management, (e) probability of the continuation of the same management, and (f) other matters which materially impact the ability of the debtor to effectuate the plan. *S & P Inc. v. Pfeifer*, 189 B.R. 173, 182 (N. D. Ind. 1992).

As part of the plan confirmation process, creditors holding claims in impaired classes<sup>1</sup> are entitled to vote to accept or reject the plan. An impaired class of claims is deemed to have accepted the plan if the plan is approved by at least two-thirds in amount and one-half the number of those casting ballots. Under Section 506(a) of the Bankruptcy Code, a creditor’s secured claim is limited to the value of its collateral. Thus, an undersecured creditor has a secured claim in the amount equal to the value of its collateral plus an unsecured claim for the portion of the debt that exceeds the collateral value. As a result, an undersecured creditor’s claim may be categorized in two different classes, and the creditor will have the opportunity to cast its votes in each of these categories.

If all classes of impaired claims accept the plan, and if the debtor satisfies all the other conditions of Section 1129(a) of the Bankruptcy Code, the

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<sup>1</sup> In general, a class of claims is impaired under the plan unless (i) the plan leaves unaltered the legal, equitable, and contractual rights of the holders of such claims, or (ii) the plan cures all pre-bankruptcy arrearages, reinstates the maturity of the claims, compensates the claim holders for damages incurred as a result of reasonable reliance on their contractual provisions, and compensates the claim holder for the actual pecuniary loss incurred from the failure to perform a nonmonetary contractual obligation. 11 U.S.C. §1124.

bankruptcy court will confirm the plan and the plan becomes binding on all creditors. However, if the plan does not receive sufficient votes in all impaired classes, the plan may be crammed down on the non-accepting class under certain circumstances. A cram down is only permitted where at least one impaired class accepts the plan and the bankruptcy court concludes that the plan does not discriminate unfairly and is fair and equitable to the dissenting class or classes.

Section 1129(b) sets forth three standards for the fair and equitable requirement. A debtor with a dissenting secured class must provide one of the following treatments: (i) the collateral may be sold and the proceeds given to the secured creditor; (ii) the secured creditor may be given the “indubitable equivalent” of its claim; or (iii) the secured creditor must retain its lien and receive deferred cash payments totaling at least the allowed amount of the claim (the Aggregate Payments Test) and such cash payments must have a present value equal to the value of the collateral (the Present Value Test).

The concept of indubitable equivalence has been addressed by the courts with widely varying conclusions. It is generally used when the secured creditor receives a return of a portion of its collateral, the balance of its secured claim continues to be secured by the remaining collateral, and the debtor proposes to pay the present value of the remaining secured claim over a period of time. *In re Sparks*, 171 B.R. 860 (Bankr. N.D. Ill. 1994).

The deferred payments alternative is the predominant cram down method. Assuming that the collateral is worth \$6.0 million and the debt is \$8.9 million, a secured creditor will have both a \$6.0 million secured claim and a \$2.9 million unsecured claim. Notwithstanding the claim bifurcation required by Section 506 of the Bankruptcy Code, a secured creditor can elect to have the entire amount of its claim treated as secured by filing an election for this treatment pursuant to Section 1111(b) of the Bankruptcy Code. This election requires that a secured creditor forfeit any distribution otherwise available on the unsecured deficiency claim. In return, this election allows the secured creditor to hold a security interest on its collateral for the full amount of its claim. By making the 1111(b) election, the Present Value Test is not altered, because the value of the collateral does not change. The Aggregate Payments Test is made more difficult

because the amount of the secured claim increases from the collateral value to the total claim outstanding. A secured creditor making the 1111(b) election does not necessarily receive a lien or a mortgage for the full amount of its claim. However, if the collateral is sold or refinanced after confirmation, the creditor is entitled to receive payments totaling the full amount of its outstanding claim. Thus, although not expressly stated in the Bankruptcy Code, the concept is that by making the 1111(b) election, the undersecured creditor will be able to benefit from any appreciation in its collateral post-confirmation (up to the full amount of its outstanding claim on the date of confirmation). If a secured creditor believes the value of the collateral will increase in the future, an 1111(b) election may be appropriate.

Consequently, a creditor needs to assess all of these possibilities, and whether it likes the treatment proposed in the plan. If the creditor does not like the treatment, it has the opportunity to vote against the plan, object to confirmation, and attempt to convince the court that one of the conditions set for in Section 1129(a) has not been satisfied by the debtor.

If a creditor has a very large claim, one strategy that it should consider is whether it can control the voting on the plan because of the size of their claim. As stated previously, in order for a class of creditors to vote in favor of the plan, more than one-half in number of the creditors, and more than two-thirds in amount in a given class, have to vote to accept the plan. Therefore, if a creditor's claim is 50 percent of the class and it votes "no," then there are only 50 percent who could possibly vote "yes"—and that 50 percent is not enough to get the two-thirds vote. Consequently, any creditor with a large claim needs to assess how big that claim is in relation to other creditors in the class, and whether it can control the voting.

### *Successful Strategies*

I believe that the mechanism established by the Bankruptcy Code and the plan confirmation process is weighted in favor of the creditor, at least to some extent, because in order for the debtor to prevail with respect to their plan confirmation, the debtor has to satisfy all sixteen conditions in Section 1129(a), and if the cramdown is utilized, the debtor also has to satisfy 1129(b)—therefore, to be successful, the debtor has to hit a home run. In order for the creditor to prevail, however, it only has to win on one of

those issues. Based on that perspective, it is difficult for a debtor to achieve a confirmation of a plan if it does not have the agreement of the creditors.

*Exercising Creditor's Rights: Understanding Your Goals*

Obtaining court approval for what a creditor wants to accomplish in a Chapter 11 case is typically a methodology of understanding what the creditor's rights are and what their goals consist of—and those goals can vary dramatically. For example, if a creditor's collateral is an operating business, the creditor may have the right to try to obtain ownership of that business through foreclosure—but the creditor may not want to do so if they are not in a position to operate that business. On the other hand, if the collateral is real estate, the creditor may want to foreclose because they may want to take possession over that real estate; indeed, in many cases the real estate lenders I have represented have felt that they could do just as good a job as the debtor in taking over their real estate and managing it. If the creditor is a licensor of intellectual property, the creditor may want those IP rights back because they may be valuable, and they may be able to license them to a new licensee. On the other hand, if you have a favorable agreement with the debtor for the use of those IP rights, or if you do not think there is a market for someone else to use those rights, you may be much more willing to negotiate to allow the debtor to continue to use those rights.

If a creditor is oversecured, it is allowed to continue to accrue and collect payment of interest. However, if the creditor is undersecured, it is not allowed to accrue or collect interest post-bankruptcy. On the other hand, the undersecured creditor is 50 percent of the way home in terms of getting relief from the automatic stay. Simply put, if you are undersecured, it is easier to get relief from the automatic stay than if you are oversecured. Therefore, knowing the value of your collateral and the dynamics of the situation is crucial to a creditor who is determining its most effective course of action in a bankruptcy case.

When I am representing a primary creditor in a bankruptcy matter who is oversecured, I generally do not recommend that it attempts to enforce its rights early on in the case. I believe that most bankruptcy judges would attempt to afford a debtor an opportunity to reorganize. Accordingly, if a

creditor comes in during the first few days of the case in an aggressive manner, I think there is a natural reluctance on the judge's part to grant relief to the creditor which might result in the end of the debtor's reorganization efforts. Rather, a creditor may want to lay back and give the debtor an opportunity to trip up on its own, and that may produce a better result in the long run.

Indeed, I believe that the real key of succeeding in a bankruptcy scenario is understanding what the creditor wants to accomplish, because that goal will not be the same in every situation. Then, counsel for the creditor must then decide how to go about achieving that goal—and that depends on the nature and extent of the creditor's collateral and other rights, the value of that collateral, and the ability of the debtor to propose a confirmable plan.

### *Timeline of a Chapter 11 Case*

The timeline for every Chapter 11 case is unique. That being said, the Bankruptcy Code sets a fairly quick time frame for the submission of a Chapter 11 plan—it is basically 120 days after the filing of the case. 11 U.S.C. §1121. However, some cases are what we refer to as “pre-packaged bankruptcies”—i.e., on the day the case is filed there is already a reorganization proposal. Filing such cases requires extensive pre-bankruptcy planning and work, so that on the commencement of the bankruptcy case the debtor is already able to explain to the court how it is going to reorganize its business. Creditors probably get paid the fastest in such cases, but they are relatively rare.

In recent years, many Chapter 11 filings have essentially been liquidations, with no real effort to reorganize. However, the fact that there will be no reorganization does not necessarily mean that the creditors are going to get paid faster because after the liquidation sale occurs, someone needs to assess the other rights and claims. This process includes a determination of whether lawsuits need to be brought for claims that the debtor may have against third parties. Consequently, the sale proceeds may be held up for some time while the process of liquidating other claims and assets takes place.

Some cases follow a normal Chapter 11 process where the plan is proposed in 120 days and confirmed within sixty days thereafter, and the debtor-in-possession is then ready to distribute money to creditors. Conversely, some cases take years; the parties in a very big and complicated case are usually unable to propose a plan in 120 days. United Airlines is an example of a Chapter 11 case where it took several years before the debtor was able to propose and confirm a plan.

Therefore, the timeline varies greatly in these cases, and the creditor does not have much control in terms of obtaining payment, because many elements of these cases are in the trustee's or debtor in possession's control. Even if the creditor does not think that things are moving fast enough in terms of receiving payment, that is a very tough argument for the creditor to make, and in most cases, the judge would be more sympathetic to either the trustee or Chapter 11 debtor in terms of the time frame. The primary action in the creditor's control is whether it elects to seek relief from the automatic stay. If the creditor seeks and obtains relief from the stay, it may get payment sooner, assuming whatever their collateral is can be turned into cash at some point thereafter.

### *Current Trends in Chapter 11 Cases*

I believe that the subprime mortgage industry is probably the most challenging Chapter 11 area at the moment due to the recession in the housing market. Many companies have filed bankruptcy and some are trying to reorganize, but there is not little business activity in that industry to support a reorganization. The airline industry is also challenging. Many airlines have sought to reorganize over the last few years, and some, like United Airlines, have emerged from reorganization proceedings. But reorganizing an airline is still very challenging because of the fluctuating fuel prices and capital requirements in that industry.

One of the more recent developments in the Chapter 11 area is the recognition of the importance of intellectual property rights. Over the last twenty-five years, there has been a greater focus on IP rights, as the opportunities for licensing and marketing have increased. Consequently, that area of the law has expanded extensively, and it is becoming more important in Chapter 11 bankruptcies. I recently had a case where I

represented an IP licensor and due to some things we were able to accomplish in that case, that creditor obtained a very favorable result. Indeed, I anticipate that IP rights will continue to be a significant aspect of Chapter 11 cases in the future.

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