Bankruptcy Outline
Fidelity

Background and Introduction

I. Should society have bankruptcy protection?
  a. There are arguments for and against it.
    i. For:
      1. Allows viable companies to regroup without causing employment reductions.
        a. Note: Large Companies are different
          i. They have better staying power, more jobs at stake, etc. Perhaps only large companies should be permitted to reorganize.
          ii. This is a political impossibility.
    ii. Against:
      1. Inefficient companies should die and their resources should be redeployed.
  b. Distinctions in the United States
    i. Almost all countries have some bankruptcy protection, but typically, control of the debtor company is transferred to a third party.
    ii. The U.S. allows management to stay in place.
      1. Note
        a. A creditor can move the court to remove management and appoint a trustee.
          i. Grounds: (1) fraud; (2) gross mismanagement.
          ii. The Board will typically resign.
          iii. The Bankruptcy Code provides first priority to the turnaround team.

II. General Notes
  a. Only a small percentage of companies ever emerge from Chapter 11.
  b. Bankruptcy is very expensive: legal fees, appraisal fees, investment bankers, etc.
  c. Recent reform efforts in the United States have failed.
    i. A controversial abortion amendment killed the bill.

Powers of Bankruptcy

I. Automatic Stay
  a. Upon the bankruptcy filing, there is an immediate federal court injunction against collection of debts, seizure of collateral, and prosecution of claims and litigated matters.
    i. The injunction is immediate, even on a weekend.
    ii. Banks cannot do setoffs against other assets.Do not violate the automatic stay: You will have to cough up what you collect and can be held in contempt if you collect knowingly.
    iii. Exception
      1. Imminent threat to health or safety
  b. Procedure
    i. After filing, the creditors receive notice when the debtor submits a petition that lists all assets, debts and creditors.
    ii. A section 341 meeting is had where the creditors get together and review the petition.
      1. This gives the debtor a forum where all the creditors are gathered together and can further a joint resolution.
    iii. Note
      1. It is important to always maintain good relationships with your creditors: This is key to success of a firm generally, and in bankruptcy.

II. Use, Sell, or Lease Property Free of Restrictive Covenants
  a. If the debtor can persuade the court that a landlord is ***adequately protected***, the debtor can sublease facilities, over objection, to a third party.
    i. ***Adequately Protected***
      1. The court will consider the subleasee's credit rating, facility modifications, the tenant mix, etc.
        a. Both parties come to the hearing to present expert evidence on whether or not the landlord is adequately protected.
        b. Notes
          i. Select a court with a sophisticated judge: NY and Delaware generally have the most experienced judges.
          ii. Society allows this because there are multiple constituents competing for the debtor's assets and we want to balance the equities between them.

c. Shopping Centers
    i. The sublease can be at a profit.
    ii. Prohibition of the sublease
        1. The tenant mix is important: You can't replace Saks with Wal-Mart
        2. Local Zoning
            a. Residential zoning will not be overturned
            b. Slight variations in commercial cases are bitterly fought cases.
        3. Rejecting the Lease
            a. The debtor can reject a long-term lease for about a year's rent.

III. Creditor's Committee
- a. Creditor representatives that protect the rights of the class
    - i. Typical functions:
        1. Review all transfers made prior to filing
        2. Move to undo transfer that were not for fair market value
        3. File a fraudulent transfer claim

IV. Obtaining Credit
- a. Is very difficult in bankruptcy
- b. Why would creditors extend credit?
    - i. Charge rates that are in accord with the risk
    - ii. ***DIP:*** Debtor in Possession Financing
        1. DIP creditor receives super priority over all other creditors
        2. Allowed only if prior creditors are adequately protected.
            - a. For adequate protection, the debtor must demonstrate that their collateral is worth at least as much as the DIP financing and the rest of the outstanding debt.
                - i. There will be intense valuation scrutiny.
- c. Accounts Payable
    - i. This form of financing typically continues in bankruptcy.
        1. Rationale
            - a. Supplier's dependence necessitates the continuing business
            - b. Note: Communicate with your suppliers to maintain good relations
        2. Typically, they do not take collateral for accounts payable
            - a. Exception: International suppliers
                - i. Letters of Credit: You can draw on a letter of credit even if the buyer goes bankrupt.

V. Executory Contracts and Leases
   a. Licensing Agreements
      i. Generally, a licensee cannot transfer rights pursuant to such an agreement.
      ii. In bankruptcy, if the debtor: (1) cures any defaults; and (2) gives the licensor adequate assurances of the assignee's performance, the debtor can assign license rights to a third party.
         1. Notes
            a. The original licensor can bid against the third party
            b. Antitrust laws still apply
               i. Courts will bend over backwards to make sure a monopoly does not result from the acquisition of a debtor's assets.

VI. Avoiding Powers
   a. Preferences
      i. Any transfers made within 90 days prior to the filing of the petition for anything outside the ordinary course of the debtor's business are recovered by the debtor.
         1. Difficult to do against pure play international companies because their law lacks a complimentary provision.
      ii. Fraudulent Transfers
         1. Any transfer made to delay the collection of a legitimate debt.
            a. Can go back 6 years if supporting state law exists.
         2. Frequently occurs in the LBO context.
   b. Strong Arm Powers
      i. Allows a bankrupt company to take priority over secured creditors that have failed to correctly perfect their security interests.
         1. The secured creditor becomes unsecured.
   c. Notes
      i. Employee bonus payments will be scrutinized: See Drexel.
      ii. If you defer salary and list it as a debt, state law that compels payment of salary earned applies: It is a crime not to pay employee salaries.

Restructuring

I. Non-Balance Sheet Assets
   a. Goodwill, Patents, etc. can be very valuable.

II. Balance Sheet Issues
   a. Inventory
      i. If it has been running up, the company may be playing with it to try and avoid violating debt covenants.
      ii. Make sure defective or obsolete goods are removed from inventory.

III. Litigation Tool

a. Bankruptcy can be used as a tool to settle mass litigation

    i. Example: Dow did this to settle the breast implant litigation

    ii. A trust, approved by the court, is created, from which the claimants can assert their right to compensation.

IV. Emergence

a. Two-Thirds of each class of creditors must vote to approve the plan.

    i. Cram Down: If (1) one class approves the plan; (2) the plan does not discriminate against any class or creditor; and (3) the plan is fair and accurate; the debtor can give a creditor a security interest in collateral and then extend the terms of payment, as long as the present value of the payments equal the present value of the prior terms.