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Wrap-Up: Tomorrow's Bankruptcy Issues

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MR. KIESELSTEIN: One trend that I'm seeing, and I think it's starting to pick up supportive case law, is the notion of short-cutting some of the requirements of § 1129, that is all the elaborate requirements you have to do to confirm the plan.

And I'll just give you one example in a couple of cases that we've done, not published opinions, but precedent from influential judges, is the notion of deemed consent for administrative claims.

The rule in Chapter 11 is if you want to get out of bankruptcy, you can compromise your prepetition claims. You can put them to a vote. But administrative claims can't be compromised. They're not a class for voting purposes. You've got to pay them a hundred cents on the dollar at confirmation or later if their claim is allowed later, or they have to agree to some other form of treatment. Section 1129 isn't quite clear on that point.

We had a couple of cases, for example *TWA-3*, after we sold the airline to Marty's client. They were thrilled with the purchase, by the way. We went to confirm our liquidating plan, and it was not clear—we thought we would be able to pay all administrative claims in full, including Marty's clients, but it was not clear whether or not we'd be able to do that. We certainly couldn't say with ironclad assurance as of the petition date that we were going to do it, and we weren't in a position to pay people on the petition date or on the confirmation date.

So we sent out, in essence, a policy notice saying, "Dear Administrative Creditors: We're not in a position to pay your claims a full hundred cents on the dollar. We understand what the Code says, but you're better off this way because under Chapter 7, you do worse. If we don't hear from you, we're just going to assume that you consented to this provision."

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We got a lot of objections, and, of course, those people who objected couldn't object to the provision itself because we were not saying you're not consenting. We understood that. You can't speak for the people who haven't been heard from. We told them, let's go off in a room. We'll work something out with you. What we worked out with them 99 times out of 100 was convincing them that they were better off just withdrawing their objection.

But Judge Walsh said proper notice was given. People had an opportunity to come in. Those that came in have now withdrawn their objections. The vast majority of people haven't been heard from, and I'm going to find that they consented to this provision. So you've satisfied their administrative claims for these purposes, for confirmation purposes.

MR. BIENENSTOCK: Did you give special treatment to those who withdrew their objection?

MR. KIESELSTEIN: No. In certain instances, some people bought their claims. Other people who wanted the thing to go away bought their claim, but that was not the debtor. That was somebody else. That was a transaction between two third parties and done in the *Teligent* case as well.

MR. FISCHER: There's no way that holds up. There's no way.

MR. KIESELSTEIN: I'm living in the real world, David. It's held up twice.

MR. FISCHER: I know, but did somebody— did I forget about this 2/3 and 50 percent, and that's for unsecureds. And now , if nobody objects you're changing the Code as to this absolute priority rule?

MR. KIESELSTEIN: But apathy is not rewarded for unsecured creditors.

MR. BIENENSTOCK: There's a Supreme Court decision that says when members of a class take and appeal the confirmation, they can't settle it by getting something extra for themselves and leave everyone else in their class with different treatment.

Anyway, you succeeded. Congratulations.

MR. KIESELSTEIN: Well, I just think that this is the type of sort of approach that you have to be increasingly clever these days, especially in these liquidating Chapter 11s, which, unfortunately, there are a ton of.

And in truth, the result, if you look only at the result, is that the Chapter 11 liquidation process was a lot better than would have been bringing the trustee in under a Chapter 11 –

MR. FISCHER: What did the unsecureds get?

MR. KIESELSTEIN: What did the unsecureds get?

MR. FISCHER: In your plan.

MR. KIESELSTEIN: They got a little piece of the action that the secured creditor was willing to throw their way.

MR. FISCHER: At arguably the expense of the other.

MR. KIESELSTEIN: That's not property of the estate. It's the secured creditor's money to part with as he will.

MR. BIENENSTOCK: They used SPM.

MR. KIESELSTEIN: Yeah, SPM, which is another way of circumventing, shall we say, the plan confirmation. Well, this is where you don't have enough to pay your unsecureds anything because your secured is not getting paid in full. You need to get something to the unsecureds, and rather than doing it in a way that would violate the absolute priority rule, the secured creditor takes a piece of their recovery and skips it down to a lower class.

MR. BAIRD: And you're a hundred percent sure that doesn't violate the absolute priority rule?

MR. KIESELSTEIN: I'm not a hundred percent sure of anything. I know what I did.

MR. BAIRD: For those history buffs, the only problem with this arrangement of bypassing the intermediate person is that the Supreme Court held that you couldn't do it because—

MR. KIESELSTEIN: That was like a hundred years ago, Doug. Come on.

MR. BIENENSTOCK: You can't do it with estate property.

MR. KIESELSTEIN: Right, you can't do it with estate property.

MR. KIESELSTEIN: And one other sort of related issue is—and this is in the sale context—the ability to sell free and clear. What does that mean, free and clear of what? There's a Third Circuit opinion again in *TWA* that came down recently where there were flight attendants who had settled a lawsuit. I think it was an age and shape discrimination lawsuit from the early '90s, and these settling parties received travel benefits, a certain amount of vouchers that they could fly.

We went to sell to American. American had no interest or intention of honoring that program. We said we could sell it free and clear of that claim. Judge Walsh ruled in our favor. It went up to the Third Circuit who has now said that it is an interest in effect. Even though it wasn't a money damage award, it could be reducible to money damages, and you could sell free and clear.

And I think the more clarity one can get about what free and clear really means, the better off from a debtor's perspective you are in using the sale route to, in essence some would say, circumvent through a severance of plan creditors' democracy. Having it be the business judgment of the debtor rather than put to a vote. So those issues I think are going to roll out.

MR. BIENENSTOCK: Is it my turn? I think there are a couple things we'll be seeing more of. This last summer we had a big steel company, Republic Technology International, in Chapter 11 in Akron, Ohio, and for a variety of reasons just couldn't put together a plan that would be confirmed. And what we did was we saved the 2,500 jobs. We preserved the secured bank debt. We gave the bond debt the value of their collateral in a new note bringing down the 450 million to 80 million by way of a Section 363 sale. I think you're going to see more situations where the company is reorganized, the jobs are saved, and value is maximized in a sale as opposed to Chapter 11 plans.

Generally as to what's on the horizon, I start with what are the drivers of our practice. The first two drivers, which I think share first place are, number one, liquidity in the high yield market. When you have high liquidity there, people don't need to resort to Chapter 11.

During the '90s the volume of debt being issued was gigantic, and the investment banks kept staffing up their distressed trading desks on the theory that if half the normal percentage of debt defaults that normally defaults, there would be an avalanche of bankruptcies in the '90s. And they kept staffing up their distress desks, and there were no defaults, practically none given the volume of debt outstanding. And the reason was it was so easy to raise high-yield debt and equity to fix problems, no one ever had to resort to Chapter 11.

That all changed in the year 2000 when liquidity in the high-yield market disappeared. Largely, or certainly a contributing factor, was the telecoms took so many billions of dollars out of the high-yield funds, and it still hasn't come back. Even though we hear about tons of capital waiting to go into the stock market, the high-yield market is still barely liquid. And while those conditions exist, any type of liquidity problem has a higher likelihood of Chapter 11 going forward.

The second driver of our business is what I call unplanned-for change. I don't subscribe to what I call the accountant's point of view or the crisis manager's point of view that failure is always due to bad management. If I subscribe to that, I would have to say that all management in the airline industry and the telecom industry and the gypsum wallboard industry, and the health care are incompetent, and that's just not the case.

There are macroeconomic changes, sometimes governmental changes that occur and that no good management has planned for. That's why I call it the driver that's unplanned-for change. And when you have 435 guys or 535 in Washington working on unexpected change all the time, you have a driver for your business all the time.

The reduction in reimbursement costs for health care facilities that Congress says it did, then relented, and then did again that's driving a whole new field of health care Chapter 11 cases simply by doing that.

The unplanned-for changes recently have been deflation. You know, I never thought the price of steel was going to go down; the price of paper, down; the price of coal, down. Deflation can be a terrible thing, especially if you're a borrower.

So since deflation remains one of Alan Greenspan's major obstacles and this country's major obstacle, I think you're going to see in the commodity industry major bankruptcies because no one can deal with deflation.

The other thing happening is that with interest rates at a little over 1 percent and equity markets basically negative, maybe marginally positive, none of the pension plans, defined benefit plans earn their hurdle rates. When you have a defined benefit pension plan, the money paid in is calculated based on how much it has to earn over time to the retiring ages of the people covered by the plan. And most companies, plus or minus, have a hurdle rate of 7-1/2 percent. You can't buy good paper today that yields 7-1/2 percent, certainly no governmental paper. And you certainly can't think that you're going to earn 7-1/2 percent in the stock market today. You may get lucky and pick a fund or a stock, but if you're a big pension fund, you cannot make those assumptions, which means you cannot make your hurdle rates.

What that means, the Pension Benefit Guaranty Corporation is going around refiguring the deficit funding, the deficiencies in all of the defined pension plans across the United States that it guarantees. This is going to cut across a lot of industries and create a lot of distress because unless the market turns around in a hurry and there's a big upside, these deficiencies are going to swallow up these submajor companies.

MR. KIESELSTEIN: And I would agree, they're huge exit hurdles for companies that are in. As we've seen with *U.S. Airways*, it had to then go back after cutting the deal, thinking it had a prepack in essence, and having to get extraordinary relief in terminating their pilot pension plan because they could not make it out of Chapter 11 without doing that.

MR. FISCHER: I think that the health care industry is going to go totally haywire because of all the states' budgetary crises. I have represented a small mental health facility that receives 90 percent of its money from the state in its reorganization. Every time the governor would say something, our rate would change. And yet society has decided, I think, that they don't care about these sorts of people, and they are tied into the nursing home industry. And any quasi health care or health care facility or social facility is a for-profit business— but anybody who is in the business of taking care of people, who society I guess has decided should be taken care of, is in for just this horrible ride. And I'm not sure that the states have figured out what they're going to do about it.

MR. BAIRD: I can identify four themes that relate to what we've been saying here. First, I am a little concerned, actually, I'm greatly concerned, by the disconnect I see between the Supreme Court's bankruptcy opinions, and many appellate courts' bankruptcy opinions on the one hand, and current bankruptcy practice on the other. A lot of current bankruptcy practice does not lead to published opinions. No one objected when United continued to honor frequent flyer miles or even their prepetition claims that—

MR. FISCHER: How about putting the people on the planes who had tickets?

MR. BIENENSTOCK: It's advertising. It's not—

MR. BAIRD: No, no, no, I know. My point, Marty, was not that United wasn't doing this, but people on the ground never think of even raising that issue. If you got up in front of the court and said to Judge Wedoff, "Judge, we have to follow the letter of the Bankruptcy Code. These are prepetition claims. This has to happen and this has to happen. We can't honor existing tickets."

MR. FISCHER: Then buy your new ticket.

MR. BAIRD: People don't behave that way in bankruptcy court but—

MR. KIESELSTEIN: Oh, no, we say these are prepetition claims, and these are—and if we can't do this, these will be the consequences.

MR. BIENENSTOCK: Everybody is worse off.

MR. FISCHER: Judge Grady would have said, no, you can't honor those prepetition tickets.

MR. BAIRD: My only point is there are 300 people in the courtroom. Everyone nods their head and think it's fine to honor existing tickets. But if it gets to 9 individuals someplace else, I'm not sure they're going to agree. I'm not saying I like it. I teach the law. I don't make it.

MR. KIESELSTEIN: You have to get the confirmation before the opinion comes out and not after.

MR. BAIRD: The second issue I would point to is following up on what they said about asset sales in bankruptcy. Even by Lynn LoPucki's count, and he I think is very, very low and undervalues this, almost half these mega cases are asset sales. His figure is 47 percent. I think it's actually higher than that. I asked Judge Fitzgerald for her opinion and she said more than half although she was talking about all Chapter 11 cases, not just mega cases. We now live in a world in which you have asset sales, a world in which we have *203 North LaSalle* and the Supreme Court saying you have to pay attention to the market, a world in which you're constantly using the market. It doesn't simply mean Chapter 11 is a good vehicle for selling these companies, which it is. It also means people are going to be thinking about the market and valuing issues in a way they hadn't before.

I was on a panel last week with one of Marty's partners, and talked about big valuation difficulties in Chapter 11. I talked about how it's hard to value assets and so forth. And Marty's partner says, "Douglas, what's your problem? We just use the market to value everything."

The idea that a lawyer from Weil Gotshal would say that to someone from the University of Chicago shows that the world is changing. Not only do we have asset sales, but also the way people think about bankruptcy is going to change whenever there are asset sales.

The third observation concerns the great frauds we've seen in the last year in bankruptcy. I don't want to exaggerate. I mean, *WorldCom* isn't a very elaborate fraud. It's primitive and disappointing. Even *Enron* pales beside some of the great frauds we've seen in, let's say, *Equity Funding* or some of the earlier cases of the last century. I don't want to say that these frauds were done with any style or finesse, but at a conference like this we might want to take stock in what's going to happen to the law, and how are we going to think about that.

I would make the following prediction, and that is that what we'll see is the rebirth of fraudulent conveyance law as we try to unwind these transactions and figure out which party who still has money is going to be tagged with what. Fraudulent conveyance law provides a very flexible instrument of doing that in part because fraudulent conveyance law comes with it an ability to recharacterize transactions. I agree, we should talk about the recharacterization process but we should recognize that the engine that can allow the recharacterization and allow the unravelling of a number of suspect transactions is fraudulent conveyance law. We need to look not only at transactions that are fraudulent conveyances because they are transfers made by an insolvent without reasonably equivalent value or transfer for less than fair consideration, but also at transactions that are fraudulent conveyances because they are "badges of fraud." Under this branch of fraudulent conveyance law, you don't have to find old-fashioned common law fraud. It's enough if a transaction has a number of suspect characteristics that serve no legitimate economic purpose or create no external changes in the world as to who was running assets or who was controlling assets. If a transaction has enough of these characteristics, it's a fraudulent conveyance even if you can't prove common law fraud and even if you can't show a transfer for less than the reasonably equivalent value.

Cases like *Enron*, *WorldCom* and *Adelphia* that have a large amount of misbehavior associated with them are likely to expand this old and venerable branch of bankruptcy law.

Finally, we should also look at the trajectory of legislative change and what that's going to mean. Two things are going on here. Congress at the moment is very unhappy about employee compensation both with respect to ordinary workers and high-level executives. The rhetoric we always use is Chapter 11 saves jobs, but the reality is when Chapter 11 is filed, the first thing that happens is a whole bunch of people get laid off and are thrown out of work. The experience of the line of everyday working-stiff employees in these large Chapter 11s on the one hand, and these very, very large payments being made to people running firms in Chapter 11 on the other is creating force for legislative change.

When you bring in a turnaround specialist with a proven track record, you can't be very surprised that he is demanding and getting a lot of money. Nevertheless, retention bonuses to existing officers are likely to come under increased scrutiny.

We are also likely to see some action in the realm of asset securitization. There is general consensus that an old-fashioned nonrecourse factoring arrangement gussied up with special-purpose vehicles and securitized will be upheld.

What we do see happening, however, is legislation that's pushing the envelope of what you can do with asset securitization. With that, come a number of different threats to the bankruptcy system and the integrity of the bankruptcy system.

In *LTV*, we had a special-purpose vehicle in which the inventory was being transferred to a special-purpose vehicle, and it is claimed that this inventory is, as a result, no longer property of the estate. Because of the lawyer's magic, Molten steel on the factory floor ceases to be property of the estate even though the debtors' employees are handling it every day.

To the extent that those kinds of transactions become more widespread, again the face of bankruptcy law may change rather substantially.