PREPACKAGED BANKRUPTCY PLANS: THE DELEVERAGING TOOL OF THE '90S IN THE WAKE OF OID AND TAX CONCERNS

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The excesses of the 80's—marked by the extreme overleveraging of many domestic companies[1] — came crashing down at the beginning of the 90's with an explosion of debt defaults, out-of-court debt restructuring and bankruptcies.[2] Even the House of Drexel — the symbol and driving force of the avarice of the 80's — filed for protection under chapter 11 of the Bankruptcy

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1 From 1981 to 1989, the annual number of public leveraged buyouts ("LBO's") grew from 99 to 251, while the aggregate value of these transactions grew from $3.1 billion in 1981 to more than $32.8 billion in 1989. *See* Cieri, Heiman, Henze, Jenks, Kirschner, Riley, Sullivan, *An Introduction to Legal and Practical Considerations in the Restructuring of Troubled Leveraged Buyouts*, 45 BUS. LAW 333 (Nov. 1989). An LBO is the acquisition of a target corporation financed by an investor group incurring significant amounts of debt, generally secured solely by the assets and earnings of the target company. *See* 21 SETON HALL L. REV. 918 (1991) (seminar discussion of LBO's). Very often, the wholesale replacement of equity capital with debt appeared to be feasible by virtue of the savings in income taxes generated by interest deductions rather than non-deductible dividends. While many LBO transactions were accomplished based on earnings projections that showed that debt service payments could be supported, in part, by utilizing the cash flow that had previously been used to pay taxes, income taxes are in fact only payable in the event the company has positive taxable income. Debt service, on the other hand, is payable (or will at least be accrued currently) in all events without regard to the company's earnings. Accordingly, the cash flow assumptions underlying numerous LBO transactions were especially sensitive to economic downturns which depressed corporate earnings. *See* Cieri, *supra* note 1, at 368 (summary of tax issues arising in connection with the restructuring of LBO's).

2 Thompson, *Cleaning Up Mike's Mess*, U.S. NEWS & WORLD REP., October 15, 1990, at 85, col. 1; Stein, *Memo to Judge Wood*, BARRON'S, September 24, 1990, at 16, col. 1; Hammer, *Fall of the Marionettes*, NEWSWEEK, July 23, 1990, at 38, col. 1. Recently failed or troubled LBO's include Revco D.S., Inc., Resorts International, Inc., Hillsborough Holdings Corporation, Federated Department Stores Inc. and Allied Stores Corporation.

Code[3] (the Code) on February 13, 1990.[4]

The methodology available to deal with the ramifications of overleveraging has been restricted by a recent controversial court decision, *In re Chateaugay Corp.*,[5] and hastily passed tax legislation,[6] which will lead to a further dramatic increase in bankruptcy filings, rather than consensual out-of-court restructurings, or "workouts,"[7] as the favored remedy to deal with the failed LBO's of the 80's. This article explores the ramifications of the *Chateaugay* decision and the interplay of United States tax policy with that decision in a "workout" situation. Absent reversal of *Chateaugay* and a prompt rescission of the recent tax legislation, the authors conclude that debt-laden companies will find that a "pre-packaged" bankruptcy under section 1126 of the Code is a more expeditious and substantially less costly procedure within which to attempt to restructure.[8]

I. BACKGROUND

The consensual out-of-court workout (or restructuring) has long been an efficient and cost-effective alternative to bank-

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3 11 U.S.C. §§ 101-1330 (1988).

4 *In re* Drexel Burnham Lambert Group, Inc., No. 90 B 10421 (Bankr. S.D.N.Y. 1990). Numerous Drexel subsidiaries thereafter also filed chapter 11 cases. Two United States governmental agencies have accused Drexel of causing the demise of many savings and loan associations. *See* Consolidated Proofs of Claim of the Federal Deposit Insurance Corporation and of the Resolution Trust Company, filed in the *Drexel* cases on November 15, 1990.

5 109 Bankr. 51 (Bankr. S.D.N.Y. 1990), appeals docketed, Nos. 90 Civ. 2974-2978, 90 Civ. 2989, 90 Civ. 2990, 90 Civ. 2993 and 90 Civ. 2994 (S.D.N.Y. 1990). *Chateaugay* was decided by Burton R. Lifland, the Chief Bankruptcy Judge of the Southern District of New York, on January 11, 1990. A notice of appeal was filed on April 9, 1990. Briefs in opposition to the decision have been filed by, *inter alia*, Valley Fidelity Bank & Trust Co., IBJ Schroder Bank & Trust Co., Team Bank and Maryland National Bank.

6 OMNIBUS BUDGET RECONCILIATION ACT OF 1990 Pub. L. No. 101-508, § 11325(a) (November 5, 1990) [hereinafter, "OMNIBUS ACT"].

7 The term "workout" has been defined as a "process rather than an event or technique," resulting in a realigned financial structure. Rome, *Business Workouts Manual*, ¶ 1.01, at p. 2 (1985). *See also* Lurey, *Participation in a Pre-Bankruptcy Workout*, 427 COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 307, 311 (1987) (workout defined as a "borrower's efforts to negotiate with its lenders for a restructuring of its debts outside of bankruptcy or other court proceedings").

8 A "pre-packaged" plan describes the procedure of devising a plan of reorganization and soliciting acceptances to such a plan prior to the commencement of a bankruptcy case. *See* Aaron, BANKRUPTCY LAW FUNDAMENTALS § 12.09; Kaplan, *Prepackaged Plan: Popular, Limited Tool*, THE BANKRUPTCY STRATEGIST, Vol. VIII, No. 1, 1 (Nov. 1990) (Part I) and Vol. VIII, No. 2, 5 (Dec. 1990) (Part II); Gross, Hahn and al-Hibri, *Restructuring Public Debt Outside Chapter 11*, 465 COMMERCIAL LAW AND PRACTICE COURSE HANDBOOK SERIES 567, 597-99 (1988).

ruptcy.[9] Moreover, bankruptcy policy encourages the negotiated resolution of disputes.[10] Workouts are usually commenced when a company is unable to pay its debts and approaches creditors seeking longer terms, deferrals, moratoriums, waivers or reductions of interest in an effort to avoid the ramifications of default.

For traditional private institutional debt, the workout is commonly negotiated between an agent or small group of lenders and the borrower. Private workouts can take many forms, including granting new collateral, or additional collateral to the lenders and requirements for the advance of additional funds, as well as longer terms and a revised interest structure.[11]

For publicly traded debt, on the other hand, such workouts have most commonly taken the form of consensual exchange offers. In an exchange offer, creditors swap existing debt instruments for substitute debt instruments; the restructured (or substitute) debt typically contains different interest or coupon rates, maturity dates, security and/or financial covenants.[12]

Typically, one of two strategies is adopted in exchange offers for public debt. The first is an attempt to capture the market

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[9] The typical complex bankruptcy lasts several years. It is a process often fraught with uncertainty and subject to substantial transaction costs, such as professional fees and expenses, which are paid for by the debtor but which ultimately serve to reduce distributions to creditors. Moreover, a bankruptcy may create a stigma which a company will find impossible to overcome even if a reorganization is successfully completed. Finally, for management-owned companies the risk that a court-appointed trustee may replace management during the chapter 11 case often makes the spectre of bankruptcy anathema.

[10] The legislative history to the Code provides:

> Most business arrangements, that is, extensions or compositions (reduction) of debts, occur out-of-court. The out-of-court procedure, sometimes known as a common law composition, is quick and inexpensive. However, it requires near universal agreement of the business's creditors, and is limited in the relief it can provide for an overextended business. When an out-of-court arrangement is inadequate to rehabilitate a business, the bankruptcy laws provide an alternative. An arrangement or reorganization accomplished under the Bankruptcy Act binds nonconsenting creditors, and permits more substantial restructuring of a debtor's finances than does an out-of-court work-out.

H.R. REP. No. 95-595, 95th Cong., 2d Sess. 220 (1977), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5787, 6179, 6180 (footnotes omitted). *See also In re* Colonial Ford, Inc., 24 Bankr. 1014, 1017 (Bankr. D. Utah 1982) (finding that "the Code encourages workouts outside, or concluded inside, chapter 11. Encouragement on both fronts is necessary because dissent from a workout may assume a variety of shapes.").

[11] *See* Rome, *supra* note 7, at 8-14.

[12] *See* Weingarten, *Consensual Non-Bankruptcy Restructuring of Public Debt Securities*, SECURITIES & COMMODITIES REGULATION, Vol. 23, No. 16, 161-63 (Sept. 19, 1990).

"discount" that debentures may be trading at in the marketplace by offering to exchange an existing debt instrument for a new debenture with a reduced principal amount — the "fair market value exchange." The second is an attempt to extend and/or modify payment terms of existing debentures, but not reduce their principal amount, in order to allow the troubled company more time to recover from its financial problems—the "face value exchange."[13] In either case, the exchange offer will only be successful if a sufficient percentage of bondholders voluntarily agree to exchange the old securities for the new ones; there is generally no procedure to bind the dissenters (or holdouts) who refuse to agree.[14] Thus, even after a successful voluntary exchange offer, a number of the old or unexchanged bonds may remain outstanding in the hands of the public.[15]

The practical effect of these different kinds of exchange offers on the company is significant. By offering its creditors a fair market value exchange, a company is able to reduce its overall debt obligations.[16] In an environment where general market prices of the bonds of LBO companies are very depressed, these companies would have a great incentive to consummate such an exchange. The fair market value exchange would also be appropriate where, in reality, the company simply cannot afford to repay its LBO debt under any foreseeable circumstances. Bondholders, on the other hand, would resist a fair market value

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[13] *See Weingarten, supra* note 12, at 166. Recent exchange offers include Freuhauf Corporation and Kane Industries, each an exchange wherein the principal amount of the debt instruments was reduced, and Best Products Co., Inc. and SCI Television Inc., each an exchange wherein the principal amount of the debt instruments was unchanged.

[14] Certain states have addressed this holdout problem. For example, under Delaware law, a corporate charter may contain a provision wherein a court may order a meeting of creditors and/or stockholders to vote on a proposed workout or exchange offer, which vote, if by a requisite statutory majority, will bind all such creditors and/or stockholders, including dissenters, as well as the company, to the terms of the workout or exchange offer. *See* DEL. CODE ANN. tit. 8 § 102(b)(2) (1983); *see also* Weingarten, *supra* note 12, at 162 n.20.

[15] Because of applicable state corporate law or the requirements of the charter and/or bylaws of the debtor, a very high percentage of acceptances — a "super majority" — is often required for approval of an exchange offer. Moreover, because of the economic consequences of the holdout problem, a debtor may itself wish to condition the exchange on an even higher acceptance rate — sometimes ninety percent or more.

[16] The federal income tax treatment of a fair market value exchange, in general, causes the issuer to recognize the amount of the debt reduction as taxable income. Several exceptions to this rule exist and issuers often try to avoid the harsh impact of such rule by structuring the exchange offer in a way to avoid or defer the attendant tax liability. *See infra* note 54 and accompanying text.

exchange without receiving at least some additional consideration (such as equity in the company) as an inducement to tender their old bonds.

In comparison, a relatively healthy company that is experiencing temporary liquidity problems may be successful in a face value exchange. Although relief from liquidity problems in the form of longer payment terms and deferred interest can be achieved, the company in this situation will remain fully liable for the original funds borrowed.[17]

The *Chateaugay* decision has made it far less attractive for public debt holders to participate in a proposed face value exchange by, in effect, penalizing such holders for their participation. *Chateaugay* holds that "original issue discount" ("OID") is created when old debt is exchanged for new debt of like face amount, with the result that, in a subsequent bankruptcy, holders who exchanged will have a lower claim than those who did not, even though the overall debt obligation of the company has not been altered.[18] This lower claim will be equal to the market value of the old bond on the date of the exchange.[19] *Chateaugay* thus creates an inequality of treatment among similarly situated creditors of a debtor which attempts a consensual non-bankruptcy workout by offering a face value exchange and thereafter files for bankruptcy protection.[20]

The problem created by *Chateaugay* has been magnified by recent amendments to the Internal Revenue Code.[21] Previously, in an exchange offer, the issue price of the new security was deemed to be at least equal to the adjusted issue price of the original (exchanged) security, and the exchange was tax-free to the debtor.[22] Now, as a result of the amendment, a publicly traded new security issued in an exchange offer is deemed to have an issue price equal to its fair market value (which will gen-

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17 The tax consequences of a face value exchange prior to enactment of the OMNIBUS ACT generally have been less clear than the treatment of fair market value exchanges. *See infra* notes 44 and 53 and accompanying text.

18 *In re* Chateaugay Corp., 109 Bankr. 51, 58 (Bankr. S.D.N.Y. 1990). *See also In re* Public Serv. Co. of New Hampshire, 3 Bankr. L. Rep. (CCH) ¶ 73, 424 (Bankr. D.N.H. 1990); *In re* Allegheny Int'l, Inc., 100 Bankr. 247 (Bankr. W.D. Pa. 1989), *appeal docketed*, No. 89-1781 (W.D. Pa.).

19 *Chateaugay*, 109 Bankr. at 58.

20 *Chateaugay* does not address the case of the fair market value exchange. As noted above, in that situation, the debtor will in fact have reduced its principal debt obligation and the norm would be a lower claim in bankruptcy for those who agree to the exchange.

21 OMNIBUS ACT, Pub. L. No. 101-508, § 11325(a).

22 I.R.C. § 1275(a)(4) (prior to amendment by the OMNIBUS ACT).

erally be equal to the value of the security on the first day that it trades), and the company will realize taxable income from discharge of indebtedness.[23] In addition, the impact of these amendments on exchanging bondholders is analogous to the impact of *Chateaugay*. The amendments create a disincentive to participate in an exchange offer because the exchanging bondholders will be required to recognize as income in each year an allocable portion of the OID created as a result of the exchange.[24]

II. ORIGINAL ISSUE DISCOUNT

Central to the inequitable treatment of creditors participating in exchange offers noted above is the concept of OID. OID is an economic term used to express the difference between the consideration received by the issuer of a debt instrument, before issuance expenses, and the stated principal amount, or face value, of that instrument.[25] This difference is commonly referred to as an instrument's "discount." Since this discount is incurred

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[23] After amendment by the OMNIBUS ACT, the Internal Revenue Code provides, "[f]or purposes of determining income of a debtor from discharge of indebtedness, if a debtor issues a debt instrument in satisfaction of indebtedness, such debtor shall be treated as having satisfied the indebtedness with an amount of money equal to the issue price of such debt instrument." I.R.C. § 108(e)(11). Except as otherwise indicated, all references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended through the date of publication of this article.

The issue price of the new debt instrument is its fair market value if it is publicly traded. If the publicly traded debt instrument was issued for property (as in the case of an exchange offer), the fair market value is determined by reference to the fair market value of such property. I.R.C. § 1273(b)(3). If the publicly traded new debt instrument is not issued for property , the fair market value is determined with reference to the price paid by the first buyer of the debt instrument. I.R.C. § 1273(b)(2). If neither the new debt nor the old debt is publicly traded, its issue price is equal to its face amount, provided that the instrument carries a stated interest rate at least equal to the Applicable Federal Rate ("AFR"). I.R.C. § 1274(a). The AFR is a statutorily mandated interest rate which is published each month by the Treasury Department and is generally used by the time value of money provisions of the I.R.C. as a benchmark for current prevailing market interest rates. *See* I.R.C. § 1274(d). If the new debt does not carry a sufficient interest rate, an imputed principal amount will be calculated to be the issue price of the instrument. The calculation essentially discounts the stated redemption price at maturity to a present value as of the issue date using the AFR as the discount rate.

[24] Because a non-publicly traded debt instrument may have an issue price in excess of its fair market value, cancellation of indebtedness income and creation of OID may be avoided in an exchange offer if neither the new debt nor the old debt instruments trade publicly. The definition of "publicly traded" is ambiguous, however, and the absolute removal of an investor's liquidity may well serve as a greater disincentive to an exchange offer than the adverse tax consequences to be avoided.

[25] *In re* Chateaugay Corp., 109 Bankr. 51, 55 (Bankr. S.D.N.Y. 1990).

by the issuing company and is part of its economic cost of borrowing, the amount of this discount is, in economic terms, imputed to the borrower as the unstated interest expense to be accrued over the life of the debt instrument and paid at its maturity.[26]

Bonds or debentures are issued at a discount when the promised rate of interest is, due to conditions in the prevailing market or certain risks associated with the debt instruments, too low to sell at par.[27] Thus, the discount on the bonds in the form of a reduced purchase price from the face value of the bonds is "in the nature of additional interest which accrues over the life of the bond and is payable at the maturity of the principal obligation."[28]

For example, assume that, in 1990, ABC Corp. issues $1,000 face amount debentures due in 1994 with an interest rate of 12%. The debentures are issued at $700 for each $1,000 face amount based upon the market's estimation of the value of the issuer's credit and prevailing market interest rates. The original issue discount, the difference between the face amount and the actual issue price, is $300, which represents the imputed interest

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26 *See* Slagle, *Accounting for Interest: An Analysis of Original Issue Discount in the Sale of Property*, 32 S.D.L. REV. 1, 21, n. 108 (1987) ("The amount of the discount represents compensation to the Lender for the use and forbearance of money, i.e., interest."); *see also* United States v. Midland-Ross Corp., 381 U.S. 54, 57 (1965) ("Earned original issue discount serves the same function as stated interest . . .; it is simply 'compensation for the use or forbearance of money.' ") (quoting Deputy v. duPont, 308 U.S. 488, 498 (1940)); Helvering v. Union Pacific Co., 293 U.S. 282 (1934) ("The difference between the capital realized by the issue and par value, which is to be paid at maturity, must be added to the aggregate coupon payments in order to arrive at the total interest paid."); *cf.* Old Colony R.R. v. Comm'r, 284 U.S. 552, 560-61 (1931) ("And as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money.").

27 *Chateaugay*, 109 Bankr. at 55 ("the 'market' is telling the issuer that the stated rate of interest is too low, and the differential between consideration paid for the debenture and the amount received by the purchaser at maturity is intended to compensate the purchaser for buying a debenture with a stated interest rate below market levels").

28 *Id.* at 56-57 (quoting American Smelting & Ref. Co. v. United States, 130 F.2d 883, 885 (3d Cir. 1942)); *accord* Slagle, *supra* note 26, at 31 (" 'Original issue discount' may be thought of as interest income and expense which is *accrued but unpaid.*") (emphasis in original) (footnote omitted). The concept of OID should be distinguished from that of a market discount. A market discount is one at which an investor buys a debt instrument (for a price less than the stated principal amount) in the secondary market as opposed to buying from the original issuer. While there is no difference to the investor as to whether he captures a market discount or OID, market discount, unlike OID, has no effect on the balance sheet or borrowing cost of the issuer. Thus, a market discount has no effect on an issuer in the context of a subsequent bankruptcy.

to be earned by the debentureholder over the life of the debenture.[29]

III. TREATMENT OF OID IN BANKRUPTCY

A. *In General*

The concept of OID takes on special meaning in the context of the claims allowance process in a chapter 11 case under the Code. Section 502 of the Code, which establishes the framework for the allowance of claims in a chapter 11 case, provides, in part, that a claim in bankruptcy will be disallowed if "such claim is for unmatured interest."[30] Thus, to the extent that OID is considered the economic equivalent of "unmatured interest," such OID will be disallowed as a claim in bankruptcy.[31]

B. *Chateaugay*

Chateaugay and other recent case law squarely hold that OID is in fact "unmatured interest" for purposes of the Code.[32] Each

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[29] The debt instrument in this example contains a stated or contractual interest rate for which interim interest payments are generally made. OID, however, is most clearly illustrated in the case of zero coupon bonds for which interim interest payments are not made, and which are usually redeemed for a balloon payment at a stated maturity date, which is higher than the original issue price of the bonds. The difference between the balloon payment and original issue price, or "unstated interest," is generally presumed to represent the "time value" which is placed upon the use of the consideration paid for the period during which it is held. In the context of a zero coupon debt instrument, or any debt instrument that does not carry a stated interest rate sufficient to induce the market to purchase the instrument for a price at least equal to the stated redemption price at maturity, OID represents the various contingent risks involved in such an investment and is, in fact, the marketplace's measurement of the "time value" or "unstated interest" of that particular debt instrument. *See, e.g.*, Slagle, *supra* note 26, at 21.

[30] 11 U.S.C. § 502(b)(2) (1988).

[31] The Code does not explicitly define "unmatured interest." However, the legislative history discussing the enactment of section 502(b)(2) provides:

> Paragraph (2) requires disallowance to the extent that the claim is for unmatured interest as of the date of the petition. Whether interest is matured or unmatured on the date of bankruptcy is to be determined without reference to any *ipso facto* or bankruptcy clause in the agreement creating the claim. *Interest disallowed under this paragraph includes post-petition interest that is not yet due and payable, and any portion of prepaid interest that represents an original discounting of the claim, yet that would not have been earned on the date of bankruptcy.*

H.R. REP. No. 95-595, 95th Cong., 2d Sess. 352 (1977); S. REP. No. 95-989, 95th Cong., 2d Sess. 62 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6308-09 (emphasis added).

[32] *See Public Serv. Co. of New Hampshire*, 3 Bankr. L. Rep. (CCH) at 97,266; *Chateaugay*, 109 Bankr. at 55; *Allegheny Int'l, Inc.*, 100 Bankr. at 250, 255. A number of other cases have implicitly assumed, without detailed discussion or analysis, that

of these cases relied upon the specific example provided in the legislative history of section 502(b)(2) as "unmatured interest."

> For example, a claim on a $1,000 note issued the day before bankruptcy would only be allowed to the extent of the cash actually advanced. If the original discount was 10 percent so that the cash advanced was only $900, then notwithstanding the face amount of the note, only $900 would be allowed. If $900 was advanced under the note some time before bankruptcy, the interest component of the note would have to be pro-rated and disallowed to the extent it was for interest after the commencement of the case.[33]

Relying upon this textual example, the bankruptcy court in each of these three cases concluded that, because the face value of the bond instruments in question was greater than the market value of such bonds at the date of issue,. the difference must be considered unstated interest under the OID doctrine. Accordingly, to the extent that the imputed interest in the particular bond instruments at issue was unamortized as of the date the bankruptcy petition had been filed, such interest was deemed to be "unmatured" and therefore was disallowed under section 502(b)(2) of the Code.[34]

Chateaugay goes further, however, and holds that in a face value exchange, *additional* OID is created.[35] In *Chateaugay*, the debtor offered to the holders of its outstanding sinking fund debentures the

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any portion of a debt obligation which represents unamortized interest is barred by section 502(b)(2). *See, e.g.*, *In re* Texaco Inc., 73 Bankr. 960, 965-67 (Bankr. S.D.N.Y. 1987) (attempt by debtholders to trigger provision of notes which allowed acceleration of unaccrued interest upon default of debtor); *see also In re* Clausel, 32 Bankr. 805, 808-11 (Bankr. W.D. Tenn. 1983) (calculating refund of accelerated finance charges in an installment loan contract); *cf. In re* Watson, 32 Bankr. 491, 493 (Bankr. W.D. Wis. 1983) (calculating accrued interest on a promissory note secured by residential mortgage).

[33] H.R. REP. No. 95-595, 95th Cong., 2d Sess. 352-53 (1977); S. REP. No. 95-989, 95th Cong., 2d Sess. 62 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6308-09, *quoted in Public Serv. Co. of New Hampshire*, 3 Bankr. L. Rep. (CCH) at 87,266; *Chateaugay*, 109 Bankr. at 55; and *Allegheny Int'l, Inc.*, 100 Bankr. at 250.

[34] *See Pub. Serv. Co. of New Hampshire*, 3 Bankr. L. Rep. (CCH) at 97,266 ("The word 'interest' in the statute is clearly sufficient to encompass the OID variation in the method of providing for and collecting what in economic fact is interest to be paid to compensate for the delay and risk involved in the ultimate repayment of monies loaned."); *Chateaugay*, 109 Bankr. at 55 ("[I]n the fact situation before this Court, unamortized original issue discount on a note or debenture is indeed unmatured interest which is not an allowable claim under Bankruptcy Code § 502(b)(2).") (emphasis omitted); *Allegheny Int'l, Inc.*, 100 Bankr. at 250 ("The facts of the instant case fit squarely within the example contained in the legislative history. The legislative history is clear; original issue discount is unmatured interest which is disallowed under 11 U.S.C. § 502(b)(2).").

[35] *Chateaugay*, 109 Bankr. at 56-57.

opportunity to participate in an exchange offer in which for each $1,000 principal of debentures, a bondholder would receive $1,000 face amount of 15% senior notes (plus a number of shares of common stock). Approximately seventy-seven percent of the old debentures were so exchanged. Thereafter, despite the successful exchange, the debtor filed for protection under chapter 11. The indenture trustees for both the old debentures and the new notes subsequently filed proofs of claim roughly equal to the aggregate face value of the debentures and notes (or roughly the aggregate amount of the company's balance sheet obligation). Over the debtor's objection, the court held that the issuance of the old debentures created OID which could be disallowed pursuant to section 502(b)(2) of the Code, and that, as a result of the debt-for-debt exchange offer, *additional* OID was created with respect to the new notes based upon the difference between the fair market value on the date of issue of the new notes (the date of the exchange) and their face amount, the unamortized portion of which was also disallowable under the Code. The fair market value of the new notes was to be measured by the market value of the old notes on the date of the exchange.[36]

The court found that the exchange constituted the issuance of new debt rather than merely a modification of the old debt instrument because maturity dates, interest rate and sinking fund requirements were all materially changed, and rejected an argument that the exchange was merely a bookkeeping entry which should be accorded no economic significance.[37] In addition, the court held that

[36] *Id.* at 58. The various holdings in *Chateaugay* were resolved on summary judgment, with the exception of the actual amount of OID to be applied to the new notes. There was a factual dispute as to the value of the old debentures on the date of the exchange, which needed to be determined by further proceedings. *Id.*

[37] *Id.* at 56. In reality, this finding ignores the fact that, in a conventional private debt restructuring, for bankruptcy purposes material changes in payment terms are never considered the issuance of a new debt instrument. *See infra* note 52 and accompanying text.

On the other hand, for federal income tax purposes, if new debt instruments "differ materially" from the old debt instruments surrendered, a taxable exchange will be deemed to have occurred. Treas. Reg. § 1001-1(a) ("Except as otherwise provided in subtitle A of the Code, the gain or loss realized from the conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent, is treated as income or as loss sustained."). The fact that an exchange offer contemplates the physical exchange of one debt instrument for another is not controlling. It is the difference in the terms of the debt instruments that will govern whether a taxable exchange has occurred. Rev. Rul. 73-160, 1973-1 C.B. 365 ("The income tax liability resulting from a particular transaction involving a change in the terms of outstanding securities is not controlled entirely by the mechanical means used for the accomplishment of the

the accretion of amortized OID in the pre-petition period should be calculated on a "yield-to-maturity basis", also known as the "constant interest", "effective interest" and "economic accrual" method.[38] Unlike the straight-line method of accounting, the yield-to-maturity basis may reduce a claim in bankruptcy even further because, under such calculation, amortization of the discount occurs more slowly with larger "interest" accruals occurring later in the life of the bond.[39] Thus, to the extent that a chapter 11 filing follows

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change."); *see also*, G.C.M. 37884 (March 19, 1979) ("The 'materially different' portion of [the] Regulation in the context of debt obligations . . . does not turn on whether or not there was a physical exchange. A contrary construction would elevate form over substance, a result we cannot sanction.") Although all of the facts and circumstances of any given exchange are relevant to the determination of whether an exchange has occurred for tax purposes, the various judicial authorities and rulings by the Internal Revenue Service have indicated that the taxable threshold is an easy one to cross. *See, e.g.*, FNMA v. Comm'r, 90 T.C. 405, 422 (1988); Prop. Treas. Reg. § 1.1274-1(c)(2); Rev. Rul. 73-160, 1973-1 C.B. 365; Rev. Rul. 87-19, 1987-1 C.B. 249; Rev. Rul. 81-169, 1981-1 C.B. 429 (9% bond exchanged for 8.5% new bond with 10 year extension of maturity date); Ltr. Rul. 8731011, Ltr. Rul. 8907049, Ltr. Rul. 8920047.

[38] *Chateaugay*, 109 Bankr. at 57-58.

[39] The "constant interest" method of determining the amortization of the OID assumes that interest is compounded over time, thus calculating that "the amount of interest which accrues each year increases with the passage of time," and that "with each subsequent year, the amount of interest which accrues is greater than the amount of interest which accrued in an earlier year." Slagle, *supra* note 26, at 19. The Internal Revenue Code requires the OID be accounted for on a yield-to-maturity basis, assigning a pro-rated portion of the total OID inherent in the debt instrument to each day that the instrument is outstanding. I.R.C. § 1272(a). In contrast, the "straight line" method utilized by the *Allegheny* court is based upon the assumption that simple interest is the appropriate method of amortizing the OID, thus concluding that the same amount of interest accrues during each day of the entire term of the debt instrument. *Allegheny Int'l. Inc.*, 100 Bankr. at 254-55. *See generally* Slagle, *supra* note 26, at 17 ("Simple interest is computed by applying the rate of interest only to the principal amount of the debt. Conversely, compound interest is computed by applying the rate of interest to the total amount of the outstanding obligation, including both principal and accrued interest.") (footnotes omitted). The *Allegheny* court adopted the straight line method based on the statement in the legislative history of section 502(b)(2) of the Code that the "interest component of the note would have to be prorated and disallowed to the extent it was for interest after the commencement of the case." H.R. REP. No. 95-595, 95th Cong., 2d Sess. 352-53 (1977); S. REP. No. 95-989, 95th Cong., 2d Sess. 62 (1978), *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6308-09, *cited with approval in Allegheny Int'l, Inc.*, 100 Bankr. at 254. After noting that the definition of "prorate" is "to divide, distribute or assess proportionately," the *Allegheny* court adopted the straight line method on the apparent basis that such method best prorates the accrued interest over the term of the loan. *Id.* (quoting *Webster's Collegiate Dictionary*, 924 (1975)), The straight line method has been strongly criticized. *See, e.g.*, Slagle, *supra* note 26, at 24 ("Hence, the [straight line] method distorts the amount of interest which accrues each year because it accrues an equal amount of interest each year, without regard to the outstanding balance owing to the obligation. Furthermore, the [straight line] method serves to distort the rate of interest

closely on the heels of an exchange offer, virtually the entire amount of the "discount" could be deemed unamortized and thus disallowed.

Chateaugay relied on § 1273(b) of the Internal Revenue Code to provide the basis for establishing that the issue price of one security issued in exchange for another having the same principal amount is the fair market value of the old security.[40] Inexplicably, however, the court failed to consider the exception provided by § 1275(a)(4) of the Internal Revenue Code[41] for determining the issue price of debt securities issued in tax free reorganizations, including recapitalizations,[42] for which most exchange offers at the time of *Chateaugay* qualified.[43] In such recapitalizations, the issue price of the new bond would never be lower than the adjusted issue price of the old bond given in exchange.[44]

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accrual by accelerating the amount of interest income which is reported in the earlier years.").

[40] Section 1273(b)(3) of the Internal Revenue Code provides, in part:

> In the case of a debt instrument which is issued for property and which . . . is part of an issue a portion of which is traded on an established securities market . . . the issue price of such debt instrument shall be the fair market value of such property.

I.R.C. § 1273(b)(3).

[41] I.R.C. § 1275(a)(4) (prior to amendment by the OMNIBUS ACT).

[42] I.R.C. § 368(a)(1)(E).

[43] *Chateaugay* also erroneously relied on the *Allegheny* decision since *Allegheny* is clearly distinguishable on its facts. *Chateaugay*, 109 Bankr. at 55-56. In *Allegheny*, the debtor offered to exchange certain debt instruments for previously issued preferred stock. Subsequent to the completion of the exchange offer, the debtor filed for chapter 11 protection. The indenture trustee thereafter filed a proof of claim for the face amount of the debentures, and the debtor objected, claiming the OID was created as a result of the exchange, the unamortized portion of which was disallowable pursuant to section 502(b)(2) of the Code. The court agreed and fixed the indenture trustee's claim at the difference between the face value of the new notes minus the selling price of the preferred stock plus any accrued OID. *Allegheny Int'l Inc.*, 100 Bankr. at 253-54.

In *Allegheny*, however, the exchange offer was a debt-for-equity exchange. Prior to the exchange, equity holders had an *interest* in, but not a *claim* against, the debtor. The debtor obviously had no obligation to repay. Therefore, the only "claim" was created at the time of the exchange, and the discount arose as a result of the true "original" issuance of the debentures; the balance sheet of the debtor reflected an increase in its liabilities for the first time.

On the other hand, in *Chateaugay*, the exchange offer was a debt-for-debt swap; the debtor's balance sheet was unaffected. Unlike *Allegheny*, the "discount" purportedly created in *Chateaugay* did not arise as a result of the "original" issuance of the debentures — the *Chateaugay* "discount" was, in fact, a result of the modification of a claim created upon the original issuance of the old debentures. The court simply failed to recognize this crucial distinction. *See* Phelan and Jernigan, *supra* note 5, at 6-7.

[44] Prior to its repeal by the OMNIBUS ACT, I.R.C. § 1275(a)(4) provided that:

> If (i) any debt instrument is issued pursuant to a plan of reorganiza-

As noted above, § 1275(a)(4) was repealed after *Chateaugay* was decided.[45] Thus, with the benefit of hindsight, if § 1275(a)(4) had been repealed at the time of *Chateaugay*, *Chateaugay's* reliance on the tax treatment of OID in an exchange offer would have been accurate. On the other hand, there is no compelling need for the bankruptcy treatment and tax treatment of OID to be similar and, for policy reasons, they should not be similar here.[46] Bankruptcy policy is rooted in the fair and equitable treatment of all creditors who are similarly situated. For this purpose, the nature of the claim has traditionally been examined from the date the original obligation was incurred.[47] Tax considerations, however, have a totally differ-

> tion . . . for another debt instrument (. . . the "old debt instrument"), and (ii) the amount which (but for this paragraph) would be the issue price of the debt instrument so issued is less than the adjusted issue price of the old debt instrument, then the issue price of the debt instrument so issued shall be treated as equal to the adjusted issue price of the old debt instrument.

I.R.C. § 1275(a)(4). One of the immediate consequences of the repeal of I.R.C. § 1275(a)(4) is to create OID in instances where new debt instruments are issued in face value exchanges. This will have the effect of requiring the bondholder to recognize as taxable income the portion of the OID attributable to each tax year that the debt instrument is held. Because OID income is "phantom income," *i.e.* income for tax purposes that is not accompanied by receipt of a cash payment, the repeal of I.R.C. § 1275(a)(4) will make face value exchange offers much less attractive to creditors than has historically been the case. While the creation of OID may be an incentive for fair market value exchanges, the consequences to the creditors is not affected by whether or not the exchange occurs within the confines of title 11 and, accordingly, will not be addressed herein.

45 OMNIBUS ACT § 11325(a).

46 Numerous cases have held that the bankruptcy treatment and tax treatment of a single transaction need not necessarily be similar. *See, e.g.*, *In re* PCH Associates, 55 Bankr. 273 (Bankr. S.D.N.Y. 1985), *aff'd*, 804 F.2d 193 (2d Cir. 1988) (holding that the transaction constituted a joint venture rather than an unexpired lease for purposes of § 365(d) of the Code, notwithstanding that the transaction was structured in form of ground lease to achieve certain benefits allowed under the tax laws); *In re* Tucker, 34 Bankr. 257, 262 (Bankr. W.D. Okla. 1983) ("Although . . . the lessor took an investment tax credit and the lessee has deducted lease rentals for income tax purposes, these few indicators are not persuasive compared with the volley of indicators of a security."); *In re* Keydata Corp., 18 Bankr. 907, 909 (Bankr. D. Mass. 1982) (purported "lease" held to be a financing arrangement in spite of the fact that "lessor" took all the tax advantages of a lease and carried the sale transaction on its books as a bona fide sale); Fox v. Peck Iron and Metal Co., Inc., 25 Bankr. 674, 682 (Bankr. S.D. Cal. 1982) (purported "sale-leaseback" held to be a financing arrangement in spite of the fact that the parties' books of account and, for some time, their tax returns, recorded the transaction as a sale and leaseback).

47 *See In re* Franklin Bldg. Co., 178 F.2d 805, 808-09 (7th Cir. 1949) (holding that bondholder claims bought at a discount properly allowed for full face amount in absence of evidence that bondholders were acting in a fiduciary capacity at the time of purchase); *In re* Lorraine Castle Apartments Bldg. Corp., 149 F.2d 55, 57-58 (7th Cir.), *cert. denied*, 326 U.S. 708 (1945) ("The property right of a bondholder is the right to receive from the debtor the entire amount the latter has promised to

ent purpose and focus. While the bankruptcy laws are concerned with maintaining the relative differences in status and priority among similarly situated creditors, the tax laws are concerned with establishing a consistent system of accounting for increases and decreases in the wealth of discrete taxpayers, in order to impose a tax on their respective net increases. Central to this system of taxation is the concept that "inchoate" or "unrealized" gains or losses are not generally to be included in the calculation of a taxpayer's income whereas "realized" gains are. The requirement that a "realization event" occurs before it is appropriate to tax a sale or exchange transaction has been included in the income tax laws since they were first enacted.[48] As long as the realization event has occurred, however, and the amount of gain or loss realized by a taxpayer can be measured, the tax laws require that the tax consequences of the transaction be determined unless some overriding economic policy requires that the realized gains or losses be deferred and not recognized currently.[49] Therefore, although an exchange offer may present a proper time to tax the participants, that fact is not relevant in the bankruptcy analysis of the relationship that similarly situated creditors have to one another and to the debtor.

A further flaw in *Chateaugay* is its failure to appreciate that the exchange offer caused no reduction in the liabilities of *Chateaugay*, and hence, no change on its balance sheet. In fact, since *Chateaugay* involved a face value exchange, the actual liability of the debtor to its old and new bondholders remained the same — the original face amount of the debt less the unamortized OID pertaining to the original debt.

Yet, by reducing the claims of the exchanged bonds under the guise of the creation of additional OID, *Chateaugay* has the effect of reducing a liability to its subsequent fair market value. This result

pay. In the absence of some equitable reason . . . the prices which security holders pay for their securities in no wise affects the measure of their participation in reorganization . . . ."); *In re* Executive Office Centers, Inc., 96 Bankr. 642, 649 (Bankr. E.D. La. 1988) (declining to limit the full value of an assigned claim against the estate in the absence of fraud or evidence of inadequate consideration); *see also In re* Dorr Pump & Mfg. Co., 125 F.2d 610, 611 (7th Cir. 1942) (holding that a claim in the hands of a purchaser or assignee has the same rights and liabilities as it did in the hands of the original claimant); Goldie v. Cox, 130 F.2d 695, 720 (8th Cir. 1942) (same).

[48] *See, e.g.*, Revenue Act of 1921, § 206(a)(6), 42 Stat. 227, 232 (imposing a requirement of a sale or exchange before a capital gain could be recognized).

[49] *See* Treas. Reg. § 1.1001-1(a). *See supra* note 37, for a discussion of when an exchange offer constitutes a realization event for tax purposes.

violates a major precept of the Code: the Code does not contemplate the valuation of liabilities; neither the interest rate, maturity date nor market value affects the initial amount of the claim against the company.[50] Traditional bankruptcy policy considerations with respect to the allowance of claims are instead intended to fix the obligations of a debtor as of the petition date by determining the amount of claims in bankruptcy and precluding the accretion of post-petition interest on particular claims.[51]

While the new note terms are in fact materially different, viewed from the perspective of the debtor, the amount of money borrowed and owed has not changed. Renegotiation of private institutional debt, with the original principal amount remaining the same, also recognizes the absence of any impact on the balance sheet of the debtor. Previously, it has not been suggested that renegotiated private debt should be reduced upon a subsequent bankruptcy to the fair market value of the debt at the time of the restructuring. However, taken to its logical extreme, and directly contrary to the traditional statutory analysis for allowing claims in bankruptcy, the *Chateaugay* analysis could, in a subsequent bankruptcy, require that every general unsecured creditor's claim that has been modified or otherwise adjusted be fixed at the fair market value of that claim on the date of bankruptcy.

To illustrate, consider the example of a bank which has extended a $100 million unsecured line of credit to a debtor. Based upon the value of the debtor's assets and prevailing conditions in the credit markets, the "fair market value" of the bank's claim is $60 million. Now suppose that the debtor renegotiates the payment terms of the debt with the bank, extending the final repayment by

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50 Fortgang & Mayer, *Valuations in Bankruptcy*, 32 U.C.L.A. L. REV. 1061, 1094-95 (1985).

51 The legislative history to section 502(b)(2) of the Code provides, in part:

> Section 502(b) thus contains two principles of present law. First, interest stops accruing at the date of the filing of the petition, because any claim for unmatured interest is disallowed under this paragraph. Second, bankruptcy operates as the acceleration of the principal amount of all claims against the debtor. One unarticulated reason for this is that the discounting factor for claims after the commencement of the case is equivalent to contractual interest rate on the claim. Thus, this paragraph does not cause disallowance of claims that have not been discounted to a present value because of the irrefutable presumption that the discounting rate and the contractual interest rate (even a zero interest rate) are equivalent.

H.R. REP. No. 95-595, 95th Cong., 1st Sess. 353 (1977); S. REP. No. 95-989, 95th Cong., 2d Sess. 63 (1978) *reprinted in* 1978 U.S. CODE CONG. & ADMIN. NEWS 5963, 6308-09.

two years, and declaring a one-year interest holiday. Six months later, the debtor files for chapter 11 protection. Under current bankruptcy law, the bank has a principal claim in bankruptcy of $100 million. Under a *Chateaugay* analysis, if taken to its logical extreme, the modifications to the line of credit could be deemed to constitute an exchange of a new obligation for the old obligation, resulting in a limitation of the bank's claim to $60 million, the fair market value of the claim.[52]

More importantly, though, the *Chateaugay* decision exacerbates the holdout problem in an exchange offer by penalizing those creditors who do participate in an exchange offer and providing even greater rewards for those who do not. By revaluing only the face value exchangor's claim downward while leaving the holdout's claim intact, the court creates a windfall for the non-exchanging holdout in a subsequent bankruptcy. The result also creates a windfall for the company by relieving its debt measured by the additional OID. Thus, *Chateaugay* gives creditors a *disincentive* to cooperate with a struggling debtor in a consensual workout and gives an artificial benefit to the debtor.

In addition to the *Chateaugay* disincentive, the repeal of I.R.C. § 1275(a)(4) will also directly impact the ability of a debtor to participate in exchange offers. Because I.R.C. § 1275(a)(4) had set the issue price (or deemed fair value) of the new debt to be no lower than the adjusted issue price of the old debt (the deemed principal amount) outstanding, discharge of indebtedness income generally was not created in a public debt exchange.[53] With the repeal of § 1275(a)(4), however, the issue price of the new debt will generally be its fair market value and the debt discharge income will be real-

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52 *See* Phelan and Jernigan, *supra* note 5, at 607. *Chateaugay* brushed aside this argument by noting the significant changes made to the new notes (revised maturity dates, and modified interest rate and sinking fund requirements), and by stating that other cases such as compromised trade claims were not before the *Chateaugay* court. *In re* Chateaugay, 109 Bankr. 55, 56 (Bankr. S.D.N.Y. 1990).

53 When a corporation satisfies its outstanding indebtedness with cash or property with a fair market value of less than the principal amount of the debt outstanding, the corporation generally is required to recognize taxable income from the discharge of indebtedness. I.R.C. § 61(a)(12). Because a debt exchange (whether a face value or a fair market value exchange) typically involves the retirement of old debt when it is trading at a discount, the risk of creation of taxable income is virtually always present.

The applicable Treasury Regulations explicitly include in the definition of discharge of indebtedness income the rule that: "If bonds are issued by a corporation and are subsequently repurchased by the corporation at a price which is exceeded by the issue price plus any amount of discount already deducted . . . the amount of such excess is income for the taxable year." Treas. Reg. § 1.61-12(c)(3).

ized, unless the debtor is insolvent or in bankruptcy, in which case the income so realized may be either eliminated or deferred, depending on the structure of the transaction.[54] As a result of the repeal of I.R.C. § 1275(a)(4), income from cancellation of indebtedness may no longer be avoided merely because the exchange offer constitutes a tax-free recapitalization transaction. Debtors that engage in exchange offers will be required to recognize all cancellation of indebtedness income that is realized on the exchange if they are not sufficiently insolvent or if the exchanges are not consummated in a title 11 proceeding.[55] Concluding the debt exchange under the auspices of title 11 will secure the exclusion from the current recognition of discharge of indebtedness income without the debtor having to admit to and prove the degree of its insolvency with all of the attendant risks of doing so.

IV. CONSEQUENCES

A debenture claim should be allowed at an amount equal to

[54] If a debtor is insolvent or if the exchange occurs under the auspices of a title 11 case, two provisions of the tax laws provide relief from the recognition of debt discharge income. In both instances, if insolvency is relied on for relief, such relief will only be available to the extent the debtor is insolvent. I.R.C. § 108(a)(3). The first form of relief, the "stock-for-debt exception," is absolute. If the debtor issues more than a *de minimis* amount of its stock to the creditors as part of the consideration in the exchange, the amount of debt discharged in excess of the fair market value of the cash, stock, new debt and other property issued is deemed discharged by the stock issued. I.R.C. § 108(e)(8) and § 108(e)(10)(B). Recently issued proposed regulations help to define what constitutes *de minimis* stock issuances. Prop. Treas. Reg. § 108 (proposed December, 1990). The OMNIBUS ACT also restricted the use of certain types of stock in exchanges that qualify for the stock for debt exception. OMNIBUS ACT § 11325(b)(1), adding new I.R.C. § 108(e)(10)(B)(ii). *See also* Rev. Rul. 90-87, 1990 — C.B. —, limiting the use of preferred stock in stock-for-debt exception exchanges. If a transaction does not qualify for the "stock-for-debt exception," insolvent taxpayers and those in title 11 cases are, nonetheless, permitted to exclude from income any debt discharge income. I.R.C. § 108(a)(1)(A)(B). The effect of such exclusion, however, is tempered by the fact that the debtor's tax attributes must be reduced by the amount of the income so excluded. I.R.C. § 108(b). The reduction of tax attributes, including net operating losses, tax credits and the debtor's tax basis in its assets, has the effect of deferring and not eliminating the debt discharge income. It should be noted that, if outside of title 11, the exclusion from gross income only applies to the extent that the debtor is insolvent. I.R.C. § 108(a)(3). Insolvency for this purpose is the excess of the debtor's liabilities over the fair market value of its assets, determined immediately prior to the exchange.

[55] *See supra* note 54 and accompanying text. Unless a debtor is under title 11, the tax protection from debt discharge income that is available is limited to the amount by which the debtor's assets actually exceed its liabilities immediately prior to the exchange. Therefore, the issue of solvency will often govern the tax treatment.

the original obligation created for the amount of money originally borrowed (less the true original unamortized OID), as provided in the Code, notwithstanding any participation in a face value exchange offer. To hold otherwise, as does *Chateaugay*, results in disparate treatment for non-exchanging creditors since the exchanged claims may be further reduced simply by virtue of the exchange, and a windfall is created for the debtor. This result directly violates the basic bankruptcy tenets that all similarly-situated creditors should be treated alike and that the claims in bankruptcy should relate to the original incurrence of the obligation.[56] Assuming *Chateaugay* is not reversed and there is no legislative correction to the repeal of I.R.C. § 1275(a)(4), bankruptcies will undoubtedly increase when distressed companies are faced with recalcitrant debentureholders who are unwilling to consent to an out-of-court restructuring because of the discriminatory treatment compared with non-exchanging holders, and because debt exchanges as part of a bankruptcy plan are the only sure way today to avoid, or at least defer, the unfavorable tax treatment described above.

These factors will undoubtedly accelerate the trend toward the ever increasing use of pre-packaged bankruptcy plans.[57]

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[56] *See supra* note 46 and accompanying text. The notion of equality of treatment among similarly situated creditors runs throughout various provisions of the Code. For example, section 1122(a) of the Code requires that a reorganization plan provide for the classification of all similar claims within a particular class under the plan so that the treatment of those claims is consistent. *See In re* B&W Enterprises, Inc., 713 F.2d 534, 537 (9th Cir. 1983) (the Code "requires that a chapter 11 plan must 'provide the same treatment for each claim or interest of a particular class.' 11 U.S.C. § 1123. There is no indication that Congress intended the courts to fashion their own rules of super-priorities within any given priority class.") (quoting 3 COLLIER ON BANKRUPTCY ¶ 507.02 (15th ed. 1979)). In addition, section 1129(b)(1) sets forth the confirmation requirement that a plan (which otherwise meets statutory requirements) may be confirmed only if it does not unfairly discriminate among creditors and it is fair and equitable. *See In re* Pine Lake Village Apartment Co., 19 Bankr. 819, 831 (Bankr. S.D.N.Y. 1982) (holding that the creation of separate classes of unsecured claims "in order to allow gamesmanship in vote getting is not condoned under the Code [and] . . . is unfairly discriminatory within the meaning of 11 U.S.C. § 1129(b)(1)").

[57] During the past year, there has been an increasing use of pre-packaged chapter 11 plans, presumably to limit the time spent in bankruptcy and to realize the significant cost savings of avoiding a full blown bankruptcy. *In re* The Southland Corporation, No. 390-37119-A-11 (Bankr. N.D. Tex.) (Dallas Division); *In re* LaSalle Energy Corp., No. 90-05508-H3-11 (Bankr. S.D. Tex.); *In re* Republic Health Corp., No. 389-38127-F-11 (Bankr. N.D. Tex.) (Dallas Division); *In re* Kroy Inc., et al., Nos. 90-5034-PHX-RGM through 90-5035-PHX-RGM (Bankr.D. Ariz.).

V. Pre-Packaged Chapter 11 Cases

A pre-packaged chapter 11 is a procedure designed to conduct a largely out-of-court restructuring which is subsequently consummated under the authority of a bankruptcy court without invoking the procedures of a full-blown bankruptcy case.[58] As a practical matter, the pre-packaged bankruptcy unfolds in a manner similar to an out-of-court exchange offer: there is a negotiation with major bondholders, the preparation of offering literature (a combination exchange offer and disclosure statement) and the negotiation of a plan.[59] A pre-packaged chapter 11, if successful, solves many of the problems inherent in an out-of-court restructuring without the cost, delay and uncertainty of a

[58] Unlike a pre-packaged plan, in a typical full-blown chapter 11 case, a petition is typically filed before negotiations with creditors are commenced. 11 U.S.C. § 1103(c)(3) (1988). Over a lengthy period of time after filing, a chapter 11 company (called the "debtor" under 11 U.S.C. § 101(12)) generally negotiates the terms of the restructuring with the statutory committees appointed under the Code. Pursuant to section 1102(a) of the Code, the United States Trustee is required to appoint a committee of creditors holding unsecured claims, and may, depending on the needs of the individual case, appoint additional committees of creditors or of equity security holders. In large and complex chapter 11 cases, multiple committees are usually appointed. *See, e.g.*, *In re* Johns-Manville Corporation, Nos. 82 B 11656 through 82 B 11676 (Bankr. S.D.N.Y.) (Committee of Unsecured Creditors, Asbestos Health Litigants Committee and Equity Committee, each appointed by the United States Trustee under section 1102 of the Code; the Unofficial Co-defendants Committee was appointed pursuant to section 1109(b) of the Code); *In re* Federated Department Stores, Inc., and Allied Stores Corporation, et al., Nos. 1-90-00130 through 1-90-00146 (Bankr. S.D. Ohio)(Western Division) (The Official Committee of Unsecured Creditors of the Federated Debtors, The Official Unsecured Creditors' Committee of Allied Stores Corporation, The Official Committee of Bondholders of Federated Department Stores, Inc., The Official Committee of Bondholders of Allied Stores Corporation and The Official Committee of Federated Pre-Merger Bondholders, each appointed by the United States Trustee); *In re* Revco D.S., Inc., et al., Nos. 588-1308 through 588-1321, 588-1305, 588-1761 through 588-1812 and 588-1820 (Bankr. N.D. Ohio) (The Unofficial Committee of Secured Bank Lenders, the Official Committee of Unsecured Trade Creditors, the Official Committee of Unsecured Noteholders and the Unofficial Preferred Equity Committee, two of which were appointed by the United States Trustee). These committees and their retained legal, accounting and investment banking professionals investigate all aspects of the debtor's financial condition and negotiate the terms of a reorganization plan with the debtor. *See* 11 U.S.C. § 1103 (setting out the duties of chapter 11 committees). Moreover, each and every business transaction out of the ordinary course of the debtor's business requires court approval under section 363 of the Code and executory contracts must either be assumed or rejected by the debtor under section 365 of the Code. As a result, the chapter 11 process is generally protracted, fraught with uncertainty, enormously expensive and essentially requires management to operate in a "fishbowl" atmosphere.

[59] *See generally* Aaron *supra* note 8, at § 12.09; Gross, *supra* note 8, at 597-99; Weingarten, *supra* note 12, at 161-62.

traditional chapter 11 case.[60]

As noted above, one of the greatest inherent difficulties of an out-of-court exchange offer is the inability to bind dissenters.[61] Since *Chateaugay* fosters a *disincentive* to bondholders in the solicitation of their consent to an exchange offer, the holdout problem will be exacerbated. Further, in an exchange offer, there are often additional economic benefits to be obtained by refusing to exchange. A holdout may obtain improved terms from the debtor as a further inducement to accept the exchange. Additionally, if the exchange offer is implemented despite the existence of holdouts, the economic value of the old debt instruments may be enhanced because the company will be in a stronger financial position after the exchange.

On the other hand, a successful reorganization under the Code eliminates the holdout problem. If the statutory majorities for acceptance of a plan of reorganization are achieved, the Code allows the will of the majority to bind dissenting creditors.[62] Thus, the dissenter must exercise whatever leverage is available to obtain the optimum return during the plan negotiation process.

Moreover, the acceptance percentage required for a successful exchange offer is often prohibitively high.[63] In contrast, for acceptance of a plan of reorganization under the Code, (i) a class

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60 Compared to a traditional chapter 11 case, confirmation of a pre-packaged plan can be accomplished within a few months. *See, e.g.*, *In re* Anglo Energy, Inc., No. 88 B 10360 (Bankr. S.D.N.Y.) (pre-packaged chapter 11 plan completed in two months), *In re* Republic Health Corp., No. 389-38127-F-11 (Bankr. N.D. Tex.) (pre-packaged chapter 11 completed in four months), *In re* Crystal Oil Company, No. 86-12834 (Bankr. W.D.La.) (pre-packaged chapter 11 plan completed in four months). Thus, the enormous transaction costs of a chapter 11 case that frequently grow exponentially with the appointment of multiple official creditor and equity committees and the requirement of court scrutiny of major transactions can be drastically reduced with a pre-packaged chapter 11. Many bankruptcy practitioners have opined that a pre-packaged chapter 11 is suitable only for companies with relatively simple capital structures. *See, e.g.*, New York Times, November 26, 1990, at D2, col. 1. *See also* Kaplan, *supra* note 8. For complex capital structures, Kaplan suggests as an alternative a "pre-negotiated" plan, which is a proposed plan negotiated with ad hoc committees and filed in full or as an agreement in principle with the bankruptcy petition. Nevertheless, pre-packaged chapter 11's have been utilized increasingly for complex recapitalizations.

61 *See supra* note 14 and accompanying text.

62 Pursuant to § 1141 of the Code, the provisions of a confirmed plan of reorganization bind, *inter alia*, any creditor or equity security holder, whether or not the claim or interest of such creditor or equity security holder is impaired under the plan, and whether or not such creditor or equity security holder has accepted the plan. *See* 11 U.S.C. § 1141.

63 *See supra* note 16.

of claims has accepted a plan of reorganization if such plan has been accepted by creditors that hold at least two-thirds in amount and more than one-half in number of the allowed claims voting, and (ii) a class of stock interests has accepted a plan if such plan has been accepted by holders of at least two-thirds in amount of the allowed interests voting.[64]

Since the pre-packaged plan is negotiated *before* the chapter 11 case starts, it can take advantage of all the benefits available under the Code without the detriments of a prolonged and expensive proceeding while binding the dissenters as well, all at a significantly lower level of required acceptances. If the pre-packaged chapter 11 proceeds promptly, significant bankruptcy court involvement will be limited to the issue of determining compliance with section 1126 of the Code and Bankruptcy Rule 3018. In addition, from the debtor's perspective, intensive investigation of its prebankruptcy affairs may be minimized.[65] For these reasons, over the past several years, pre-packaged chapter 11's increasingly have been utilized by debtors in combination with or in lieu of traditional exchange offers.[66] The use of pre-packaged plans will undoubtedly increase to minimize the risks created by *Chateaugay* and to avoid the adverse tax consequences created by the repeal of § 1275(a)(4) of the Internal Revenue Code.

A. *Section 1126(b) of the Code*

Section 1126(b) of the Code and Bankruptcy Rule 3018 set out a procedural roadmap for a debtor to follow in order to consummate a pre-packaged chapter 11. Section 1126(b) of the Code permits a debtor to formulate a plan of reorganization prior to commencement of a chapter 11 case and to obtain acceptances or rejections of such plan by holders of claims and interests.[67]

The solicitation of such acceptances or rejections must be in

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[64] 11 U.S.C. § 1126(c). There is no quorum requirement for this vote, with the result that a relatively few creditors who have an actual interest in voting for or against a proposed plan often can control the vote.

[65] In the *Anglo Energy* chapter 11 case, no creditors' committee was appointed. In *Southland*, a creditors' committee comprised of creditors with whom the debtor had already negotiated in the prepetition period was appointed by the United States Trustee as an official creditors' committee. *See infra* notes 72-93 and accompanying text.

[66] *See supra* note 56.

[67] The section provides:

> (b) For the purposes of subsections (c) and (d) of this section, a holder of a claim or interest that has accepted or rejected the plan

compliance with any applicable non-bankruptcy law, rule or regulation governing disclosure of adequate information or, if there is not any such law, such acceptance or rejection is solicited after disclosure of adequate information to such holders pursuant to section 1125(a) of the Code.[68]

B. Adequate Disclosure

Once the plan of reorganization has been formulated, the disclosure requirements of section 1126(b) are the key to a successful pre-packaged chapter 11. Because the solicitation of the pre-packaged plan will occur prior to the filing of the petition, the timing of the bankruptcy court's review of the disclosure statement is reversed. In a typical chapter 11 case, the bankruptcy court approves the disclosure statement under the adequate information standard set forth in section 1125(a) of the Code prior to solicitation of acceptances of a plan but after the case has been commenced.[69] All creditor objections to the ade-

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> before the commencement of the case under this title is deemed to have accepted or rejected such plan, as the case may be, if —
> (1) the solicitation of such acceptance or rejection was in compliance with any applicable non-bankruptcy law, rule, or regulation governing the adequacy of disclosure in connection with such solicitation; or
> (2) if [sic] there is not any such law, rule, or regulation, such acceptance or rejection was solicited after disclosure to such holder of adequate information, as defined in section 1125(a) of this title.

11 U.S.C. § 1126(b) (1988). Pre-packaged reorganization cases were not uncommon under the former Bankruptcy Act. The legislative history to section 1126(b) recognized that prepetition solicitation was "common practice under [former] Chapter XI." *See, e.g.*, *In re* NJB Prime Investors, 3 Bankr. 553 (Bankr. S.D.N.Y. 1979). Prepetition solicitation was expressly authorized under Chapter XI of the former Bankruptcy Act. *See* BANKRUPTCY ACT of 1898, § 97, 30 Stat. 544 (repealed 1978).

68 The effect of the securities laws on the disclosure required for a pre-packaged chapter 11 is discussed in section B. There are a significant number of additional securities law issues involved in consummating a pre-packaged plan which are beyond the scope of this article. For example, the prepetition solicitation may subject proponents to liability under various antifraud provisions of the securities laws. *See* Securities Exchange Act of 1934, § 14(a), 15 U.S.C. § 78n (1989) (governing proxy solicitations and requiring disclosure of material facts); Securities Exchange Act of 1934, Rule 14a-9(a), 17 CFR § 240.14a-9(a) (1987) (precluding false and misleading statements and omissions of material facts in connection with proxy solicitations); Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78 (1989) (prohibiting use of manipulative or deceptive devices in connection with the purchase or sale of a security; Securities Exchange Act of 1934, Rule 10b-5, 12 CFR § 240.10b-5 (1987) (precluding false and misleading statements and omissions of material facts). *See generally*, Weingarten, *supra* note 12, at 161-66; Epling & Thompson, *Securities Disclosure in Bankruptcy*, 39 BUS. LAW. 855 (May 1984).

69 Pursuant to section 1125(a)(1) of the Code, "adequate information" is defined as:

quacy of disclosure are reviewed and can be cured or overruled prior to bankruptcy court approval.

To the contrary, in a pre-packaged chapter 11, both disclosure and solicitation occur prior to filing. Once the chapter 11 case is filed, under section 1126(b), the bankruptcy court is required to make a retroactive finding in respect of the adequacy of disclosure.[70]

As previously noted, section 1126(b) requires that the solicitation of the pre-petition plan of reorganization comport with the disclosure requirements of applicable non-bankruptcy law or section 1125(a) of the Code. The section 1125(a) standard for disclosure is available only to a non-public company. For a public company, "applicable non-bankruptcy law" means that the disclosure statement must comply with the Securities Exchange Act of 1934 and the rules and regulations promulgated thereunder.[71] Thus, the disclosure statement must be submitted to the Securities Exchange Commission ("SEC") for comment and clearance by the SEC corporate finance and reorganization staff.

At first blush, submission to the SEC may appear burdensome, but because the requirements of the securities laws are typically more stringent than the scope of information generally required under section 1125(a)(1), clearance by the SEC of the information contained in the disclosure statement should materially assist the debtor in satisfying the bankruptcy court that the

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

11 U.S.C. § 1125(a)(1). The drafters of the Code clearly intended to allow the bankruptcy courts to determine what constitutes adequate information on a case-by-case basis. H.R. No. 95-595, 95th Cong., 1st Sess. 408 (1977); S.R. No. 95-989; 95 Cong., 2d Sess. 120 (1978). It has been held that the determination of what constitutes adequate information is subjective and largely within the discretion of the bankruptcy court. Texas Extrusion Corp. v. Lockheed Corp. (*In re* Texas Extrusion Corp.), 844 F.2d 1142, 1157 (5th Cir. 1988); Nevord-Sanford v. Mabey (*In re* A.H. Robins Co.), 880 F.2d 694, 696 (4th Cir. 1989).

[70] The legislative history of section 1126 states that "[t]his [section] permits the court to ensure that the requirements of section 1125 are not avoided by pre-petition solicitation." H.R. REP. No. 595, 95th Cong., 1st Sess. 410 (1977).

[71] 15 U.S.C. § 78a-78kk (1988 & Supp I. 1990). Section 1145(a) of the Code exempts securities issued under a plan from the registration requirements of the federal securities laws. In the context of a pre-packaged chapter 11 plan, the section 1145(a) exemption remains viable because new securities will, in fact, be issued under a plan of reorganization confirmed within a chapter 11 case. 11 U.S.C. § 1145(a).

disclosure statement did indeed provide "adequate information."[72] Once the disclosure statement has been cleared by the SEC, the pre-petition solicitation can commence.

C. *Rule 3018(b)*

Bankruptcy Rule 3018(b) applies to the actual solicitation in a pre-packaged chapter 11, and it sets forth additional procedural requirements that must be followed by the debtor.[73] Essentially, Bankruptcy Rule 3018 permits the proponent of the plan to obtain before the commencement of the case and to file with the bankruptcy court the acceptance or rejection of (i) the holder of a claim or interest which is deemed allowed pursuant to section 502 of the Code,[74] (ii) a creditor who is a security holder of record[75] at the date specified in the solicitation and whose claim has

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[72] Section 1125(d) of the Code specifically excepts postpetition chapter 11 disclosure from the requirements of the federal securities laws, permitting the SEC to be heard in the bankruptcy court on disclosure, but not to appeal from an adverse determination. 11 U.S.C. § 1125(d). Section 1125(e) of the Code is a companion safe harbor provision absolving a proponent of such solicitation from any liability under federal securities laws. 11 U.S.C. § 1125(e). There is no authority that these exemptions are available in a prepetition solicitation. For purposes of postpetition disclosure, a bankruptcy court is under no duty to analogize to the securities laws. Kirk v. Texaco, 82 Bankr. 331 (S.D.N.Y. 1988). However, in the chapter 11 case of *The Southland Corp.*, the bankruptcy court requested that the SEC render a report on the debtor's compliance with the securities laws under section 1126(b).

[73] FED. R. BANKR. P. 3018(b) provides:

> *Acceptances or Rejections Obtained Before Petition.* Acceptances or rejections of a plan may be obtained before the commencement of a case under the Code and may be filed with the court on behalf of (1) the holder of a claim or interest which is deemed allowed pursuant to § 502 of the Code or allowed by the court; (2) a creditor who is a security holder of record at the date specified in the solicitation for the purposes of such solicitation and whose claim has not been disallowed; and (3) an equity security holder of record at the date specified in the solicitation for the purposes of such solicitation and whose interest has not been disallowed.
>
> A holder of a claim or interest who has accepted or rejected a plan before the commencement of the case under the Code shall not be deemed to have accepted or rejected the plan if the court finds after notice and hearing that the plan was not transmitted to substantially all impaired creditors and impaired equity security holders, that an unreasonably short time was prescribed for such creditors and equity security holders to accept or reject the plan, or that the solicitation was not in compliance with § 1126(b) of the Code.

FED. R. BANKR. P. 3018(b).

[74] Section 502 sets forth the requirements for allowance of claims against the debtor. 11 U.S.C. § 502.

[75] In a recent memorandum opinion, the United States Bankruptcy Court for the Northern District of Texas held that only the holder of a claim, creditor or the holder of an interest, may accept or reject a plan. *In re* Southland Corp., 124 Bankr.

not been disallowed and (iii) an equity security holder of record at the date specified in the solicitation and whose interest has not been disallowed. Significantly, Bankruptcy Rule 3018 further provides that the bankruptcy court will not approve the acceptance or rejection of the plan by a holder of a claim or interest if, after notice and hearing, the bankruptcy court finds that the proposed plan had not been transmitted to substantially all impaired creditors and impaired equity security holders,[76] an unreasonably short time was prescribed for such creditors and equity security holders to accept or reject the plan[77] or that the solicitation was not in compliance with section 1126(b).[78]

211, 227 (Bankr. N.D. Tex. 1991). The court further held that if the record holder of a debt is not the owner of the claim, or a true creditor, he may not vote unless there is a certification that such record holder is an authorized agent of the creditor. *Id.* If a record holder represents more than one creditor, there must be compliance with Bankruptcy Rule 2019. *Id.* Because the court found the reference to record holders contained in Bankruptcy Rule 3018 to be in conflict with the Code, which speaks only of holders of claims and interests, the court held that such reference in Bankruptcy Rule 3018 is an attempted substantive change in the statute that is of no force and effect. *Id.*

76 Pursuant to section 1124 of the Code, a class of claims or interests is "impaired" under a plan of reorganization unless (a) the plan leaves unaltered the legal, equitable or contractual rights to which the holder of the claim is entitled, (b) notwithstanding contractual provisions or applicable law that entitle the holder of a claim or interest to demand or receive accelerated payment after default, the plan cures any actual default, reinstates the maturity of such claim or interest and compensates the holder for any actual damages, or (c) the claim or interest is paid in full, in cash, under the plan. 11 U.S.C. § 1124.

77 The bankruptcy court in *Southland* found that an initial solicitation period of 8 business days, even though such time period was subsequently extended, was an unreasonably short period of time. *Southland*, 124 Bankr. at 226.

78 Because of the absence of bankruptcy court review of pre-packaged chapter 11 disclosure prior to solicitation, the procedural requirements set forth in Bankruptcy Rule 3018 for a pre-petition solicitation are more detailed than the Code requirements for a post-petition solicitation. *See* Advisory Committee Note to Bankruptcy Rule 3018 ("This provision [Bankruptcy Rule 3018] together with § 1126(e) [disqualifying acceptances not procured in good faith] gives the court the power to nullify abusive solicitation procedures.").

In *Southland*, the debtor agreed to provide soliciting broker dealers with a fee in connection with the vote on the plan, and retained a bank or depository agent to tabulate the vote. *Southland*, 124 Bankr. at 213. The bankruptcy court stated that the solicitation fee created a conflict of interest between the broker-dealer and its customer that could taint the good faith of the solicitation process. *Id.* Moreover, the bankruptcy court was concerned that the depository agent was given broad discretion to determine which ballots would be deemed valid. *Id.* Finally, the bankruptcy court expressed concern about the complexity of the ballot form that was utilized. *Id.* *See also In re* NJB Prime Investors, 3 Bankr. 553 (Bankr. S.D.N.Y. 1979) ("In the scheme of a chapter 11, the debtor may solicit acceptances before the court can pass on the validity of the plan; but the court must examine those acceptances to make sure that they comply with the Act and are, in fact, volitional expressions of a creditor's willingness to accept a plan. True, the law is liberal as to the form of an

Two of the procedural requirements set forth in Bankruptcy Rule 3018 must be carefully complied with because the bankruptcy court is required to make retroactive findings with regard to the mechanics of the pre-petition solicitation. First, the debtor must ensure that substantially all impaired creditors and equity security holders are solicited. In the case of registered debt or equity securities, the lists maintained by indenture trustees or stock transfer agents can be utilized, but some thought must be given to the solicitation of holders whose securities are held in street name.[79]

The language of Bankruptcy Rule 3018(b)(2) and (3) appears to allow the debtor itself to establish appropriate record dates for purposes of the solicitation. In the case of impaired trade or ordinary course of business creditors where the debtor elects to freeze its payables at some time prior to the solicitation, this class must be carefully identified and solicited.[80]

Second, the debtor must ultimately show in the bankruptcy court that creditors and equity security holders were given a reasonable time to accept or reject the plan of reorganization. While Bankruptcy Rule 3018 does not set forth a time period for the solicitation, compliance with the twenty-five day notice period required for confirmation of a plan set forth in Bankruptcy Rule 2002(b)(2) in a normal chapter 11 case should be sufficient.[81]

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acceptance, requiring only that it be in writing and signed by the creditor or his agent. But it is necessary that the writing 'clearly identify the plan proposed by the debtor as the one being accepted . . . .' Where an acceptance was signed before the chapter 11 petition was filed, it is essential that it clearly appear that the creditor accepted a settlement offer on the same terms as the arrangement proposed by the debtor in the chapter 11 case." (quoting 8 COLLIER ON BANKRUPTCY ¶ 5.23(4) (14th ed.)).

79 In *Southland*, the court held that beneficial owners of securities, that is actual creditors and holders of equity interests and not record owners, are entitled to vote under the Code. *Southland*, 124 Bankr. at 226-27. Therefore, where representatives of beneficial owners vote, there must be disclosure of the beneficial owner plus a certification that the representative is entitled to vote on its behalf. *Id.*

80 A debtor with severe financial difficulties may stretch out actual payment of its ordinary course payables to conserve cash. In contemplation of a chapter 11 filing, a debtor will often freeze payments on all payables as of a certain date. Such action may allow a debtor to build a war chest to assist in financing a chapter 11 case. In the case of a pre-packaged chapter 11, it may be necessary to impair a class of trade creditors and obtain the acceptance of such class for confirmation of the plan of reorganization. *See* 11 U.S.C. §§ 1129(a)(10), (b). Therefore, all payments to such creditors must cease prior to solicitation.

81 Considering the problem with securities being held in street name discussed above, *supra* at notes 75 and 79, and that the receipt of the solicitation materials in a pre-packaged chapter 11 may be the first indication that many creditors and equity

Southland is the first significant decision interpreting section 1126(b) of the Code, Bankruptcy Rule 3018 and the mechanics of a prepetition solicitation.[82] In that case, the debtor originally allowed only eight business days for creditors and holders of interests to vote. The debtor, relying on the language of Bankruptcy Rule 3018, solicited only *record* holders of claims and interests. Thus, solicitation materials were sent only to broker dealers who held securities in street name. Such broker dealers were also provided with a solicitation fee. The debtor utilized a single ballot for the numerous classes of debt and equity that was lengthy and complex. The debtor also retained a bank to tabulate the votes and the bank was given broad discretion regarding which votes would be counted as valid. A group of creditors objected to the mechanics of the solicitation.

The bankruptcy court held that eight business days constituted an unreasonably short solicitation. The bankruptcy court discussed the mechanics of the debtor's solicitation and made several observations that should be carefully considered in any future pre-petition solicitation.

First, the court observed that the broker-dealer solicitation fee constituted an inherent conflict between the broker-dealer and its creditor customer. In *dicta*, the court stated that this fee arrangement, while common in exchange offers outside of a bankruptcy context, cast doubt on the good faith of the solicitation. Second, the bank retained to tabulate the vote, which, the court observed, was not well versed in bankruptcy voting requirements, made value judgments about whether and how certain ballots would be counted.[83] The court stated that, under the circumstances, a true vote was impossible to determine.

The most significant part of the *Southland* decision, however, concerned the court's interpretation of Bankruptcy Rule 3018 and the solicitation of record holders. The court stated that section 1126 of the Code, and all subsections thereof, utilizes the words "holders of claims", "claims", "interests" and "creditors", and there is no mention of "record holders".[84]

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holders have that the debtor is in need of a restructuring. A debtor would be well-advised to consider a somewhat longer solicitation period.

[82] *Southland*, 124 Bankr. at 223-27. *See infra* notes 92-94 and accompanying text.

[83] In a typical chapter 11 case, the vote on a plan is generally certified by the debtor and/or its counsel. However, it is not uncommon for a third party tabulator to be retained to tally the vote.

[84] The court cited U.S. v. Ron Pair Enterprises, 489 U.S. 235 (1989), for the proposition that the plain meaning of legislation should be conclusive, except in

While the court noted the use of *record* holder in Bankruptcy Rule 3018, it found that the focus was still on actual creditors and equity security holders. Accordingly, the court held that references in Bankruptcy Rule 3018 to record holders constituted substantive changes in the Code that are of no force and effect.[85]

The court ordered a resolicitation and held that, if votes were cast by broker-dealers or other representatives, (a) there must be disclosure of the true identity of the holder of the claim or interest and (b) a certification of authority to vote in a representative capacity. Further, if a representative acts for more than one creditor or interest holder, the representative must file a statement under Bankruptcy Rule 2019(a) in respect of the facts regarding its representation of such entities.

D. *The Chapter 11 Case*

It is only after receipt of all requisite acceptances that the chapter 11 case is commenced by the filing of a petition.[86] If all goes well, the first substantive event should be a combined hearing on the disclosure statement and confirmation of the plan.[87] At that hearing, the bankruptcy court is required to find that the solicitation of acceptances and rejections was in compliance with section 1126(b) of the Code and Bankruptcy Rule 3018. In order to make that finding, the bankruptcy court must "qualify" the acceptances upon a showing that substantially all creditors and eq-

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those cases where a literal application produces a result clearly at odds with the drafter's intent.

85 In authorizing the United States Supreme Court to prescribe "Rules of Practice and Procedure under Title 11," Congress also provided that "such rules shall not abridge, enlarge, or modify any substantive right." 28 U.S.C. § 2075 (1978).

86 11 U.S.C. § 301. Simultaneously with the filing, there are additional administrative requirements that must be completed. Schedules of assets and liabilities, and a statement of the debtor's financial affairs in conformity with the Bankruptcy Code, Bankruptcy Rules and Official Forms must be completed and ready to file with the petition. 11 U.S.C. § 521. FED. R. BANKR. P. 1007; Official Forms 6 and 8. A motion and proposed order fixing a bar date for the filing of proofs of claim and interest must also be prepared. FED. R. BANKR. P. 3003(c)(3). Finally, a motion must be prepared requesting immediate authority to send a notice to creditors and equity security holders fixing a single date for a hearing on (i) approval of the disclosure statement, (ii) acceptance of the plan or reorganization and (iii) confirmation of the plan.

87 In *Southland*, a group of bondholders who were unhappy with the proposed terms of the pre-packaged plan sought to form a committee of dissenters to assert objections to the disclosure statement and plan. Motion and Memorandum of Individual Debentureholders for Order Pursuant to 11 U.S.C. § 105(a) and 1102(a)(2) Directing Appointment of Additional Creditors' Committee Representative of Non-Tendering Debentureholders, dated October 29, 1990. This motion was denied in an unreported decision from the bench on November 9, 1990.

uity security holders were solicited,[88] that the solicitation period was reasonable and that disclosure was adequate under section 1126(b).[89] Thereafter, a typical confirmation hearing can proceed with testimony showing that the confirmation requirements under section 1129(a) of the Code have been met.[90]

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[88] Prior to the hearing, the debtor should carefully review all filed proofs of claim and interest and evidence should be presented showing whether substantially all of the holders of such claims and interests were in fact solicited.

[89] Because the bankruptcy court must find under section 1126(b) of the Code that the pre-petition disclosure was adequate under applicable non-bankruptcy law, a separate finding that disclosure is adequate under section 1125(a) of the Code is not technically required. *See* Kaplan, *supra* note 8, at 1. In practice, many debtors still request that the bankruptcy court make a finding under section 1125(a). Such a request was made in the *Anglo Energy* case and the bankruptcy court made disclosure findings under both section 1126(b) and section 1125(a). *Anglo Energy*, Case No. 88B 10360 (Bankr. S.D.N.Y. 1988).

[90] Pursuant to section 1129(a) of the Code, a plan may be confirmed by order of the bankruptcy court if each of the following requirements is met:

- section 1129(a)(1) requires that the plan comply with all applicable provisions of the Code;
- section 1129(a)(2) requires that the plan proponent comply with all applicable provisions of the Code;
- section 1129(a)(3) requires that the plan be proposed in good faith and not by any means forbidden by law;
- section 1129(a)(4) requires that all payments of fees to professionals made in connection with the chapter 11 case be disclosed and approved by the bankruptcy court as reasonable;
- section 1129(a)(5) requires the disclosure of any individual proposed to serve as an officer, director or voting trustee of the debtor after confirmation of the plan;
- section 1129(a)(6) requires that any regulatory commission with jurisdiction over the rates of the debtor approve any changes in rates provided in the plan;
- section 1129(a)(7) requires that, with respect to each class of impaired claims or interests, the plan is in their best interest in that the holders of each such claim or interest has either accepted the plan or will retain or receive under the plan property of a value as of the effective date of the plan not less than that which such holder would receive in a liquidation under chapter 7 of the Code;
- section 1129(a)(8) requires that each class of claims and interests either has accepted the plan or is not impaired under the plan;
- section 1129(a)(9) requires that the holders of certain administrative or priority claims receive cash in the allowed amounts of such claims on the effective date of the plan or deferred cash payments;
- section 1129(a)(10) requires that, if a class of claims is impaired under the plan, at least one class of impaired claims has accepted the plan (without including any acceptance of the plan by any insider);
- section 1129(a)(11) requires the court to find that the plan is feasible in that confirmation is not likely to be followed by the liquidation, or the need for further financial reorganization, of the debtor;
- section 1129(a)(12) requires that all fees due under 28 U.S.C. § 1930 be paid on the effective date of the plan; and
- section 1129(a)(13) requires that a plan provide for the contin-

VI. SELECTED CASE STUDIES

Numerous recent cases illustrate the use of pre-packaged chapter 11 plans:

A. *Anglo Energy, Inc.*[91]

The pre-packaged chapter 11 of Anglo Energy, Inc. ("Anglo") is an example of the reorganization of a company with a relatively simple capital structure. In *Anglo*, senior secured obligations of approximately $108,000,000 (the result of a prior chapter 11 plan of reorganization confirmed in 1986) were effectively swapped for new common shares representing slightly less than 80% of the equity of the reorganized debtor. Unsecured trade creditors were impaired under the plan, but received 50% of their claims in cash at consummation of the plan, and 50% thirty days thereafter. Existing shareholders (and holders of warrants) were substantially diluted.

In the *Anglo* chapter 11 case, there were no objections raised regarding the pre-petition solicitation or confirmation. The *Anglo* chapter 11 was confirmed 45 days from the filing date and consummated 26 days thereafter.

B. *Southland Corporation*[92]

The Southland Corporation ("Southland") was the subject of a 1987 LBO which was financed, in part, by the public sale of various notes and debentures aggregating approximately $2 billion dollars (the "public debt"). The Southland restructuring began as an exchange offer to holders of the public debt and preferred stock. In March 1990, Southland agreed to sell a seventy-five percent (75%) ownership stake to Ito-Yakada Co. a long-time business partner. In conjunction with the sale of stock, an initial exchange offer was made to holders of the public debt in July 1990, conditioned upon ninety-five percent (95%) accept-

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ued repayment of retiree benefits for the duration of the period that the debtor has obligated itself to provide such benefits.

11 U.S.C. § 1129(a).

To the extent that a class has not accepted the plan during the pre-petition solicitation, the cramdown provisions set forth in section 1129(b) of the Code are available for the debtor to utilize to seek confirmation despite the rejection by such class. The debtor should disclose the possibility of cramdown in its solicitation. If there is a non-accepting class, the debtor can proceed with the requisite showing required under section 1129(b).

91 Case No. 88 B 10360 (Bankr. S.D.N.Y.).

92 Case No. 390-37119-A-11 (Bankr. N.D. Tex.)(Dallas Division).

ance by holders of each issue of public debt and preferred stock.[93] The exchange offer did not receive the requisite acceptances. Thus, in October 1990, Southland modified its exchange offer solely to add a pre-packaged chapter 11 option where it reserved the right to use the acceptances in a subsequent chapter 11 case.

A group of dissident bondholders seeking a sweetened deal challenged the *Southland* solicitation. Ultimately, the debtor amended the plan improving the offer to certain classes of debt, including the class represented by the dissident bondholders. The objection was withdrawn and the case was confirmed on February 21, 1991. The case was actually commenced on October 24, 1990.

Despite the litigation surrounding the solicitation, Southland is an example of a pre-packaged chapter 11 of a debtor that was the subject of an LBO and had a complex capital structure. The case illustrates that the pre-packaged chapter 11 is well-suited to the multiple recapitalizations that will be required as a result of the over-leveraged transactions consummated in the 1980's.

C. *Republic Health Corp.*[94]

Republic Health Corp. ("Republic") was the subject of a leveraged buyout by REPH Acquisition Company ("REPH") in 1986. Commencing in September 1989, REPH and Republic, companies with complex capital structures, commenced a major recapitalization.

Under the recapitalization, shareholders were asked to approve a merger agreement (the "Merger") between Republic and REPH pursuant to which REPH would be merged into Republic with Republic being the surviving entity. The effect of the Merger would be to convert the outstanding preferred and common shares of REPH to Republic common shares, and to cancel outstanding REPH warrants. As a result, the shareholders of REPH would be substantially diluted.

The second component of the recapitalization was a series of exchange offers to holders of public debt securities of both REPH and Republic (the "Exchange Offers").

The debtors initially sought to consummate the Merger and

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[93] *See* Appendix I.

[94] Case No. 389-38127-F-11 (Bankr. N.D. Tex.)(Dallas Division).

Exchange Offers outside of chapter 11. For the Merger, approval of 50% of each class or REPH shareholders was required. For the Exchange Offers, 100% acceptance was required for certain public debt issues and 90% for other public debt issues. If the Merger and the Exchange Offers could not be consummated outside of chapter 11, the debtors proposed to utilize the acceptances received in the subsequent filing of pre-packaged chapter 11.[95]

The Exchange Offers and the Merger did not receive the requisite acceptances to be consummated outside of a chapter 11 case. In December of 1989, Republic filed its pre-packaged chapter 11. The pre-packaged plan was confirmed in four months.

VII. SUMMARY

As noted above, other than the recent *Southland* decision, there is little caselaw construing the provisions of section 1126 of the Code and Bankruptcy Rule 3018, presumably because pre-packaged chapter 11's were used infrequently until recently. The use of pre-packaged chapter 11's will undoubtedly increase as a result of the *Chateaugay* case, the repeal of § 1275(a)(4) of the Internal Revenue Code and the significant savings in time and money resulting from the use of a pre-packaged plan. As the number of such cases increase and the experience with pre-packaged plans becomes more widespread, unforeseeable pitfalls to such use may develop. The difficulties in the mechanics of the *Southland* solicitation illustrate that debtor's counsel must utilize extreme care to assure that disclosure is adequate and that the procedure of the solicitation cannot be attacked. Nevertheless, absent reversal of *Chateaugay* and reinstatement of tax relief such as existed in the now repealed § 1275(a)(4) of the Internal Revenue Code, debt-laden companies have little to lose in trying to restructure their capital base under a pre-packaged plan, and much to gain. After all, a full blown bankruptcy will always be an available last resort.

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95 The terms of the Merger and the Exchange Offers in the pre-packaged chapter 11 were slightly different from the terms used for the non-bankruptcy recapitalization and are summarized at Appendix II.

Appendix I
The Southland Corporation Exchange Offer

Tendering holders of public debt and preferred stock were offered the following exchange:

For Each $1,000 Principal Amount or Share, As Applicable, of:	Holders Will Receive:
13½% Senior Extendible Reset Notes due December 15, 1995 and extendible to June 15, 1997 (the "Old Senior Notes")	$475 principal amount of 12% Senior Notes due December 15, 1996 (the "New Senior Notes"), 86.5 shares of Common Stock of the Company (the "Common Stock") and $57 in cash
15¾% Senior Subordinated Notes due December 15, 1997 (the "Old Senior Subordinated Notes")	$650 principal amount of 5% First Priority Senior Subordinated Debentures due December 15, 2003 (the "New First Priority Debentures") and 40.5 shares of Common Stock
16½% Senior Subordinated Discount Notes due December 15, 1997 (the "Old Senior Subordinated Discount Notes")	$555 principal amount of New First Priority Debentures and 35 shares of Common Stock
16¾% Subordinated Debentures due December 15, 2002 (the "Old Subordinated Debentures")	$500 principal amount of 4.5% Second Priority Senior Subordinated debentures (Series A) due June 15, 2004 (the "New Second Priority Series A Debentures") and 28 shares of Common Stock
18% Junior Subordinated Discount Debentures due December 15, 2007 (the "Old Junior Subordinated Debentures")	$257 principal amount of 4% Second Priority Senior Subordinated Debentures (Series B) due June 15, 2004 (the "New Second Priority Series B Debentures") and 11 shares of Common Stock
15% Cumulative Exchangeable Preferred Stock, Series One, $25 liquidation preference per share (the "Old Preferred Stock")	One share of Common Stock

APPENDIX II
THE REPUBLIC HEALTH EXCHANGE OFFER

For each $1,000 principal amount of:	The Exchanging Holder will receive from the Company:	Common Stock Ownership Under Non-Bankruptcy Recapitalization:	Common Stock Ownership Under Bankruptcy Recapitalization:
10.5% Debentures	$808.41 principal amount of New First Notes	—	—
11.5% Debentures	$808.41 principal amount of New First Notes	—	—
15% Debentures	$100 in cash	—	—
	New Second Notes in an aggregate principal amount equal to the sum of (i) $550 plus (ii) an amount equal to $550 multiplied by 4% per annum calculated from July 1, 1989 through the closing date of the Exchange Offer for the 15% Debentures		

	Warrants to purchase five shares of Common Stock at $10.00 per share		
13½% Debentures due 1999	40 shares of Common Stock	37.08%	37.55%
12½% Debentures due 2004	40 shares of Common Stock	33.69%	34.14%
13% Debentures	40 shares of Common Stock	17.03%	17.07%

THE MERGER

For each share of:	The REPH Stockholders will receive from the Company:	Common Stock Ownership Under Non-Bankruptcy Recapitalization:	Common Stock Ownership Under Bankruptcy Recapitalization:
REPH Preferred	.31653 shares of Common Stock	6.65%	6.13%
REPH Common	.11215 shares of Common Stock	5.55%	5.11%