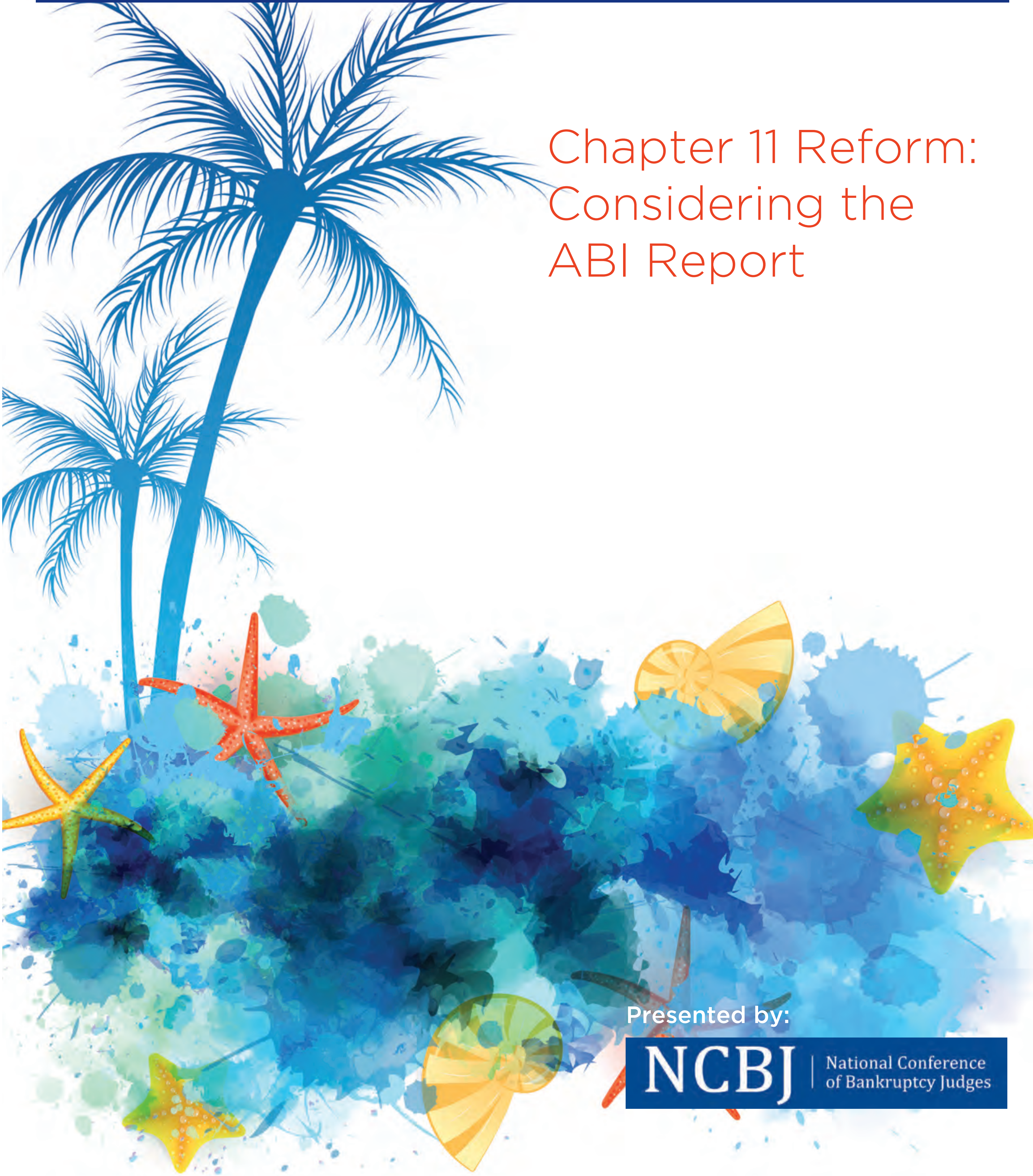
Educational Materials

Monday, September 28, 2015 | 11:45 AM – 12:45 PM

Chapter 11 Reform: Considering the ABI Report



Presented by:

NCBJ | National Conference of Bankruptcy Judges

Chapter 11 Reform:
Considering the ABI Report

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NCBJ 2015

Considering the ABI Report: DIP/Adequate Protection

J.L. Vris and R. Keach 2015

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Overview

- Use hypotheticals to test the effect of the ABI Commission's recommendation
- Two hypotheticals present basic lending structures in a layered capital structure: one with two distinct business lines with separate financings; and the second with first and second lien financing across both lines of business.
- Compare the outcome under various suppositions: out of court; chapter 11 now; chapter 11 with the ABI Commission recommendations. Test whether the recommendations promote the goals of sections 364 and 361.
- We articulate the basic goals of the section 364/361 provisions as increasing the ability of the debtor in possession to have access to liquidity without impairing the value of existing liens.
  - Possible reasons for the stated goals:
    - Avoid liquidation
    - Improve odds of successful restructuring
    - Maximize recovery of creditors
- Proposition to test: the ABI Report addresses DIPs that attempt to use liquidity leverage for plan outcome, but it cannot completely "legislate" in advance for issues created by structural complexities, financing innovations, and intercreditor squabbles. Still need judicial discretion. Does the Commission report get the balance right?

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The ABI Commission Report Recommendation: Sec. 361

- To determine the amount of adequate protection required, use foreclosure value.
- Foreclosure value is the net value received upon a hypothetical, commercially reasonable foreclosure sale of the collateral under nonbankruptcy law. Assume can structure the foreclosure in a manner to maximize value of the collateral.
- The court may use excess collateral value as adequate protection but if the cushion, or "value differential," is at some point not sufficient, the court should allow a sale of the collateral under sec. 363 unless the secured lender agrees otherwise. Sec. 507(b) priority should continue.
- Cross-collateralization is permitted to provide (but only to the extent necessary to provide) adequate protection of the petition date value. (Currently, the courts are split on this.)
- No special interest on avoidance actions for adequate protection, although the proceeds can be used to satisfy sec. 507(b) priorities. At time of confirmation, the secured creditor should be entitled to receive the reorganization value, consistent with intent of sec. 506.

The ABI Commission Report – Sec. 364

- Certain provisions would be prohibited in <u>interim</u> DIP financing orders:
  - — Milestone provisions
  - — Representations about the validity of the liens
  - — Rollups, although refinancing with proceeds of third party financing is permitted
- In all DIP financing orders, the following would be prohibited --
  - — Rollups unless (1) *either* it is by third parties not holding the prepetition debt *or* the prepetition lenders are advancing substantial new credit <u>and</u> (2) best interests of the estate
  - — Liens on avoidance actions
  - — Milestones prior to the 60th day following the petition date
- Intercreditor Agreements ("ICA") would be limited as follows:
  - — Prohibitions on the junior lienholders providing DIP financing would not be enforceable (and no damages).
  - — This special override would not allow the junior lienholders to prime the senior lienholders.
  - — If the junior lienholders are financing in reliance on the special override, the senior lienholders should have a ROFR.

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First Hypothetical: Hotelco

Hotelco

- Globalco is owned 100% by PE Shop. PE Shop created Globalco in 2012 in order to purchase a hotel developer, manager and owner, Hotelco. The purchase was through a new subsidiary which now holds all the equity of Hotelco and is itself wholly owned by Globalco.
- Debt at Hotelco and its intermediate holding co used to refinance pre-acquisition debt and finance the acquisition is $1.2 billion. The intermediate holdco and Hotelco have granted liens on their assets, pledging the equity in their (domestic) subsidiaries to secure the debt, and all domestic subsidiaries have guaranteed it. The real estate and hotels all have secured financing specific to each property. The property level debt prohibits liens on the mortgagees' collateral.
- Another subsidiary of Globalco, Intangibleco, has several subsidiaries which hold the reservation system, the IP and the management service group. Intangibleco is a credit party and the lenders have a lien on the equity of its subsidiaries. Its subsidiaries are not credit parties; they are unrestricted subsidiaries.
- **Note**: If one of the credit party files on the Hotelco side, as a result of cross-defaults and guarantees, all of the credit parties have to file.

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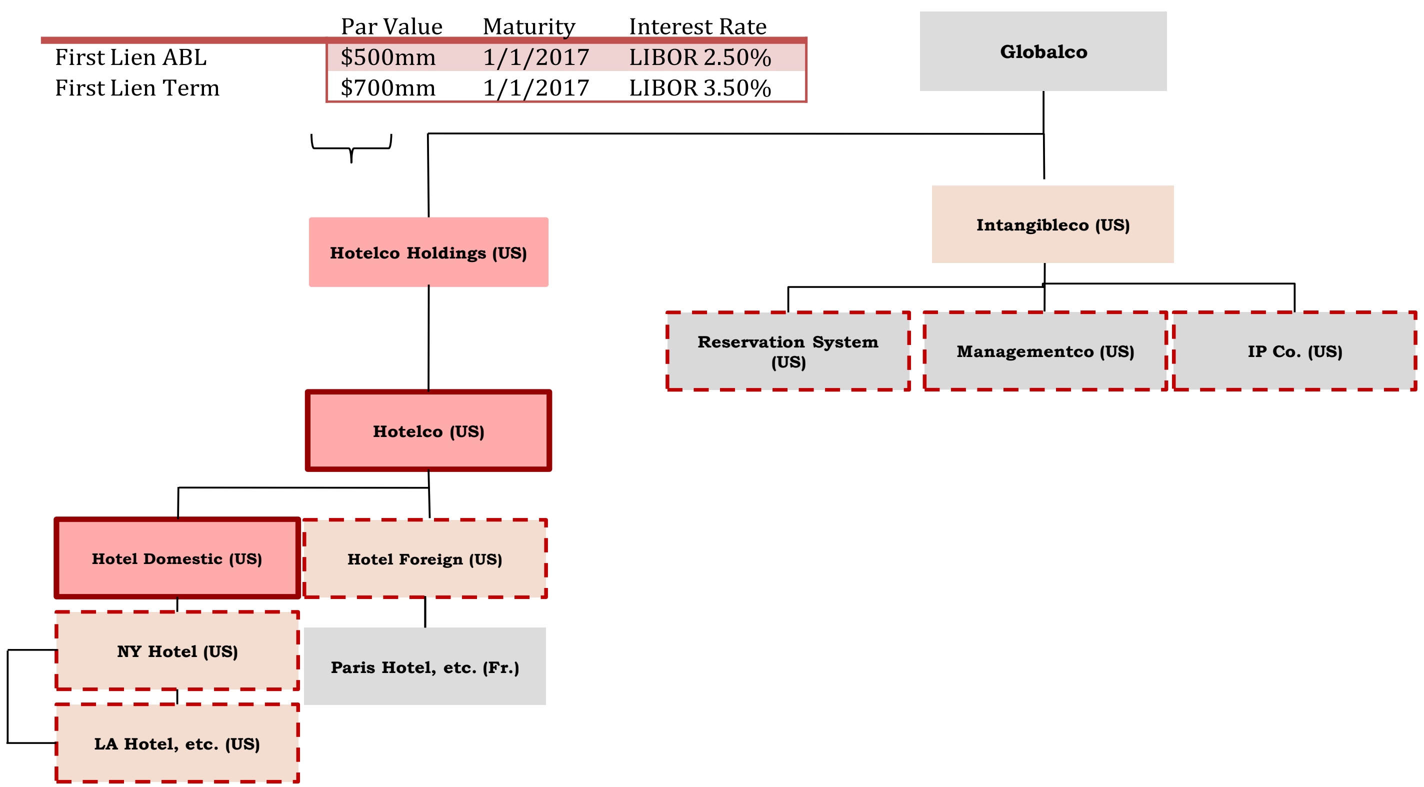
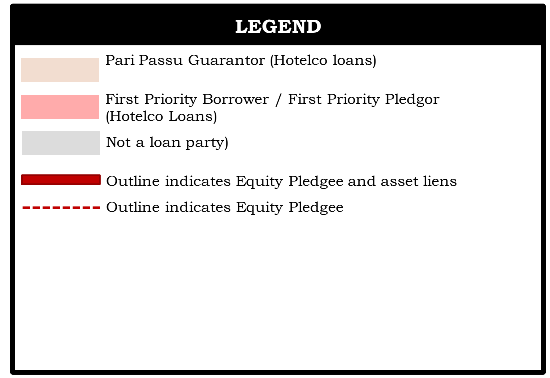
Corporate and Capital Structure: Hotelco

	Par Value	Maturity	Interest Rate
First Lien ABL	$500mm	1/1/2017	LIBOR 2.50%
First Lien Term	$700mm	1/1/2017	LIBOR 3.50%





First Hypothetical: Cruiseco

Cruiseco

- After the acquisition, with Hotelco going smoothly, there is considerable equity value at Globalco. Globalco decides to leverage off the brand, the reservation system and the terrific management group. It purchases a 50% interest in an offshore JV to acquire, build and rebrand cruise ships under Globalco's name. Globalco created Cruiseco to hold the JV interest. The initial funding for Globalco's interest was $225 million, financed with a loan to Globalco and Cruiseco jointly. The loan is short term and secured by a pledge of the equity of Cruiseco and the entity holding the JV interests. In addition, Globalco has guaranteed it. Globalco expects to refinance it once all ships are built and operating. Management services, reservations and IP are also held at the same sister subsidiaries as for Hotelco under Intangibleco.

- Under the JV arrangement, the foreign JV partner was also the builder and received financing from a local bank under a government program to create jobs. It did not put the $200mm in up front, but contributed finished ships that require cap ex to rebrand and refurbish, and it was to contribute $200mm of building services and labor for building the new ships and refurbishing the existing ships. The foreign bank has been taken over by the government and the JV partner's funding is cut off. Cruiseco has contractual rights to protect itself, but needs $200mm additional funding to complete the refurbishment of the existing boats and have construction of the boats in progress finished by another builder or its investment will rust away at its JV partner's shipyard.

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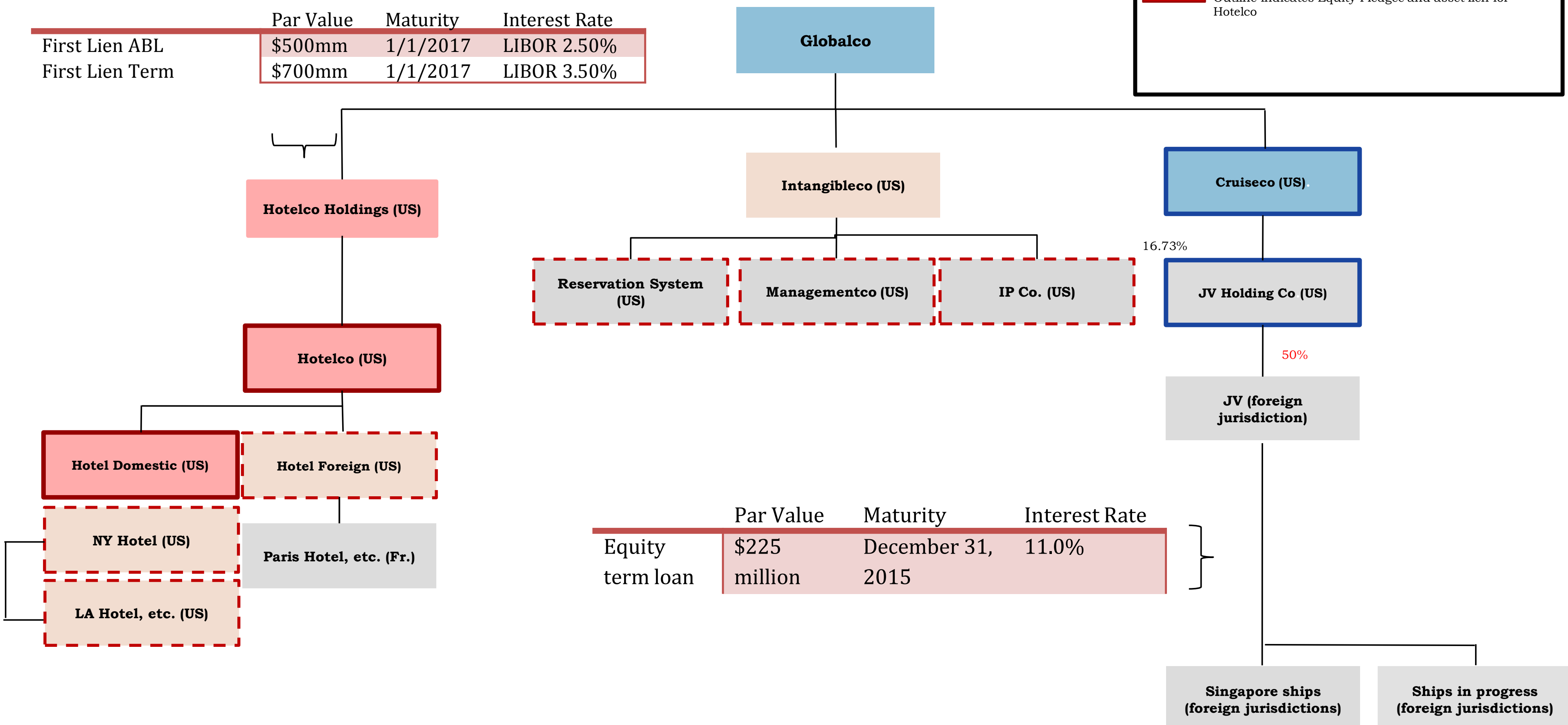
Corporate and Capital Structure: Hotelco/Cruiseco

LEGEND

- Guarantor (Hotelco loans)
- First Priority Borrower / First Priority Pledgor (Hotelco Loans)
- First Priority Borrower/First Priority Pledgor (Cruiseco Loans)
- Outline indicates Equity Pledgee for Cruiseco
- Outline indicates Equity Pledgee for Hotelco
- Outline indicates Equity Pledgee and asset lien for Hotelco

	Par Value	Maturity	Interest Rate
First Lien ABL	$500mm	1/1/2017	LIBOR 2.50%
First Lien Term	$700mm	1/1/2017	LIBOR 3.50%



	Par Value	Maturity	Interest Rate
Equity term loan	$225 million	December 31, 2015	11.0%

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Scenarios for First Hypothetical

- The lender to Cruiseco is willing to advance an additional $200mm to Cruiseco as long as Cruiseco files for chapter 11 and the lender has tight control over the budget and the timeline for getting the ships finished or the debtor must do a 363 sale of the JV interest. Notice to trigger the ROFR in the JV Agreement must be given to the lender in escrow day one with court approval as part of the first day orders to trigger the ROFR at the lender's stalking horse credit bid amount.

- The lender to Cruiseco is willing to advance an additional $200mm to Globalco and Cruiseco together as long as it gets liens in the IP and the reservation system held in the subsidiaries under Intangibleco.

- The PE Shop is willing to fund an additional $200mm into Cruiseco as long as it can prime the existing lender to Cruiseco.
  - It may be willing to give the lender a new lien in the IP and the reservation system in exchange but will also want the existing lender to extend the maturity on its debt and reduce the interest rate. The PE firm may be willing to give a lien in the French and other foreign hotelco subsidiaries.

- The lender to Cruiseco is willing to advance an additional $200mm as long as it gets a priming lien on the hotel group.

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Second Hypothetical

- Same as the first except that the lending was not done in separate groups. Instead, there are two facilities, a first lien and a second lien facility. Each has the full collateral package described above: Credit parties are Hotelco and its domestic subsidiaries, Cruiseco, the other holding companies (one above Hotelco and one below Cruiseco), and Intangibleco. Collateral consists of equity pledges of the domestic entities and liens in the assets of the borrowers. Globalco itself is not a credit party; and the equity of Hotelco and Cruiseco has not been pledged.

- Note that Hotelco holds its interest in the hotels through two direct domestic subsidiaries. One of the direct subsidiaries holds all the domestic hotels through domestic subsidiaries, and the other holds the foreign hotels through foreign subsidiaries. No lender has a lien on the shares of the foreign subsidiaries or on their assets. There is a considerable amount of cash "trapped" in the overseas Hotelco subsidiaries.

- There is no immediate default, but if Cruiseco cannot recoup its investment and begin to generate cash flow, Globalco will be facing certain financial covenant default. It needs new financing to refurbish and complete the ships and/or a covenant modification from the first and second lien holders.

- Note: If one of the credit parties files at either Hotelco or Cruiseco, then as a result of cross-defaults and guarantees, all of the credit parties have to file.

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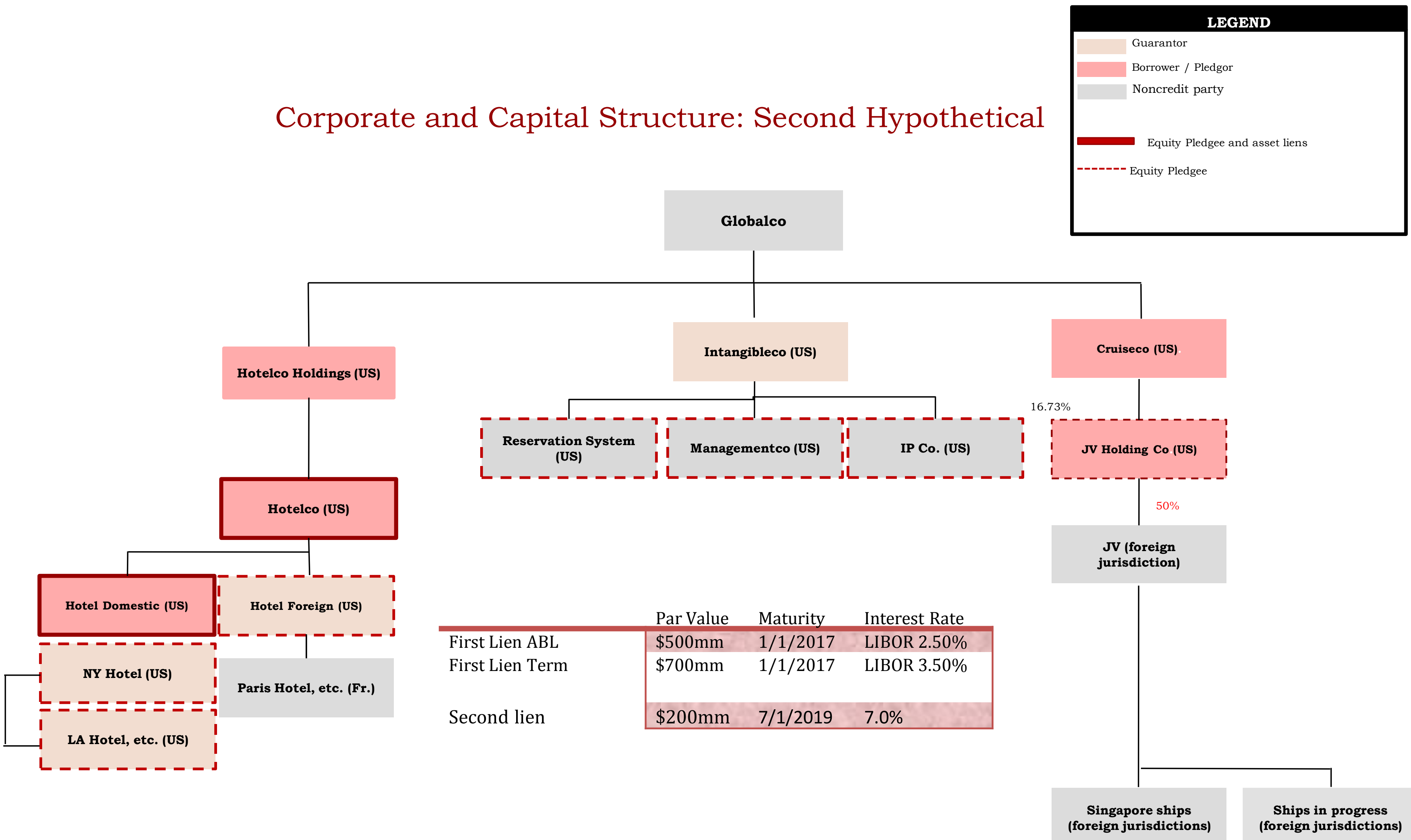
Corporate and Capital Structure: Second Hypothetical



	Par Value	Maturity	Interest Rate
First Lien ABL	$500mm	1/1/2017	LIBOR 2.50%
First Lien Term	$700mm	1/1/2017	LIBOR 3.50%
Second lien	$200mm	7/1/2019	7.0%

Scenarios for Second Hypothetical

- The first lien lenders do not like the cruise business and are willing to fund the completion of the ships but only to get to a sale of Cruiseco.
- The first lien lenders are willing to fund to a sale under a DIP financing but also want a rollup of their prepetition debt.
- The seconds are willing to provide the DIP without a rollup but only if they can get a lien on the assets of Intangibleco. And possibly a second lien on the properties down at the hotel subsidiaries.
- A new lender is willing to lend against Intangibleco's, its subsidiaries' and the foreign subsidiaries' shares and assets.

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Hypothetical on Small and Medium-Sized Enterprise ("SME") Cases
National Conference of Bankruptcy Judges Annual Meeting
September 2015

In 1946, upon returning from service in World War II, Harry Andrews (known as Gramps) saw opportunity in manufacturing home grown jams and jellies and started a small distribution company. Over the years, the distribution business expanded and by 1980, it employed over 100 people, delivering products to restaurants over a 7 state area. Gramps' family also grew, with the births of Harry II (generally known as Junior), Harriett and Harold. Only Junior was involved in the business. Harriett was committed to finding herself (it was the 70s after all) and Harold just wasn't committed to much other than spending the money Gramps would give him. A daily consumption of jams and jellies, while good for business, wasn't so great for Gramps' health and he wasn't getting any younger. Concerned about the future of the company, but not trusting lawyers-who does-purchased a mail order legal kit and ultimately incorporated the business. He gave Junior, Harriett and Harold each a ¼ ownership interest, keeping ¼ for himself. Now feeling better he didn't bother with making a will or even telling the kids about the ownership change.

A few years later, Gramps went on to that big strawberry patch in the sky. Junior continued to operate the business as Gramps had and Harriett and Harold continued to be uninvolved. By 2010, Junior had retired. Junior's only child Harry Andrews III (generally known as Trey) was the new boss with big and new ideas (it was the new century after all). Harriett (still looking) was in pretty good health and didn't have any children. No one really knew where Harold was as Gramps was no longer supporting him.

By 2015, Harold was home and "acting" as the bookkeeper. Harriet believed she had found herself in the world of young adult fiction and was also involved part time in the family business. She was responsible for the license for Katniss Nightlock Berry Jam - a winner and the Dauntless cake mix, which set sales records. Some customers even pre-paid for deliveries of the Nightlock Berry Jam and Dauntless cake mix. However, it was clear that some of Trey's big ideas weren't doing all that well. Drone delivery wasn't popular with the restaurants (patrons complained about surprise jam attacks), food trucks didn't work very well for canned goods and the expansion into New York City was a traffic "jam" disaster. It was clear that what needed to happen was a return to basics. However, by that time the family was "fighting" with each other as to who was to blame for the bad results and the company owed $4.5 million to its suppliers which amounts were seriously past due and was also in default for another $2,000,000 to the local bank, which amount was personally guaranteed by the family and also subject to the bank's lien on various company assets. While still successful product lines, the company was past due on its license payments to the Hunger Games and Divergent trademark owners and needed a new truck fleet to replace the drones.

The family had no doubt that all that was needed was a bit of time and money. Correct????

Trey was advised by a local lawyer that all that was needed was a series of informal meetings with the trade suppliers and the bank to "work it out" and in that way the family could save the enormous expense of a court supervised proceeding (aka Chapter 11) – money the company didn't have - and in following this path, the family could also maintain control of the business. While "music" to the family's ears, was this realistic advice?

To make things even more complicated Harold had once again disappeared; this time with the deposits for employee withholding taxes. Taking the lawyer's advice, the family met with its vendors, some of whom showed support but a good number had sold their claims to Snow Factor Company which was, to say the least, not at all cooperative in the settlement being offered by the company. The meeting with the bank was not much better, with the bank's President J. Matthews advising the family that, while hopeful they would choose wisely, he would not wait very long before foreclosing. While clinging to the hope that the company could be "saved", the family was fast coming to the realization that the business would not generate enough revenue to pay all vendors and other creditors in full over any reasonable period.

Harriett heard from a Hunger Games buddy that filing Chapter 11 was the way to go despite the lawyer's contrary advice which, of course, wasn't working.

Under current law and under the Commission recommendations:

- How can the substantial costs of a restructuring be minimized, as much as possible, if the company decides to file for relief under Chapter 11?
- How can the company/family receive credible financial and reorganization advice that will give the company the tools necessary to determine if reorganization is possible and, if "doable" bring credibility to the company's restructuring plan with its creditors?
- Who needs to approve this restructuring?
- Can the family obtain relief from its secured lender as a result of the filing?
- Can the family maintain control of the business?
- What could be done with the Dauntless and Hunger Games trademark licenses?

Chapter 11 Reform: Considering the ABI Report

NCBJ 89th Annual Meeting September 28, 2015

Excerpts from ABI Commission Final Report and Recommendations (dated December 2014)

Adequate Protection

Recommended Principles:

- The amount of adequate protection required under section 361 of the Bankruptcy Code to protect a secured creditor's interest in a debtor's property should be determined based on the foreclosure value of the secured creditor's collateral.
- Nothing in this principle prohibits the trustee from seeking to sell a secured creditor's collateral under section 363; in such a sale, the secured creditor's allowed secured claim should be determined by the value actually realized from the sale of its collateral under section 363. In the case of a chapter 11 plan contemplating a reorganization of the debtor, the secured creditor's allowed secured claim should be determined by the reorganization value of its collateral. For the definition of "reorganization value" (which is defined for both the plan and the section 363x sale contexts), see Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.
- For purposes of these principles, the term "***foreclosure value***" means the net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable nonbankruptcy law. In evaluating foreclosure value, a court should be able to consider a secured creditor's ability to structure one or more sales, or otherwise exercise its rights, under applicable nonbankruptcy law, in a manner that maximizes the value of the collateral. In the case of a foreclosure sale in which the secured creditor would acquire the collateral through a credit bid, the foreclosure value should be based on the net cash value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale, and not on the face amount of the debt used to acquire the property through the credit bid.
- The foreclosure value of a secured creditor's collateral should be determined at the time of the request for, or agreement by the parties to provide, adequate protection under section 361. In granting adequate protection to a secured creditor under section 361(3), the court should be able to consider evidence that the net cash value that a secured creditor would realize upon a hypothetical sale of the secured creditor's collateral under section 363 exceeds the collateral's foreclosure value (a "***value differential***"). If the court makes a finding based on the evidence presented at the adequate protection hearing that a value differential exists, the court should be able to premise adequate protection under section 361, in whole or in part, on such value differential. In so doing, the court's order also should provide that, if the court determines at a subsequent hearing that the secured creditor has presented sufficient evidence to warrant relief from the automatic stay with respect to the collateral, the trustee will conduct a sale of the collateral under section 363, unless the secured creditor elects otherwise. For purposes of this principle, the court may not enforce any waiver or agreement affecting a court's ability to consider evidence and make

determinations regarding the existence of a value differential or a secured creditor's entitlement to relief from the automatic stay.

- This formulation of adequate protection complies with the original purpose of section 506(a), which provides that value "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a). Accordingly, the foreclosure value of a secured creditor's collateral should not necessarily determine the value of such collateral or the secured creditor's allowed claim for other purposes in the chapter 11 case.
- A secured creditor should continue to receive priority treatment under section 507(b) for the foreclosure value of its collateral at the time of its request for adequate protection under section 361. To the extent existing law has been interpreted by courts to mean that the secured creditor must be "provided" with adequate protection in order to gain this benefit, such case law should be overturned by statute. It is sufficient that the secured creditor be deprived of the requested relief from the automatic stay to implicate the protections of section 507(b).
- A court should be able to approve a provision to cross-collateralize a secured creditor's prepetition debt with the debtor's or the estate's postpetition property only for the purpose of providing adequate protection under section 361 and only to the extent that such cross-collateralization covers any decrease in the value of the secured creditor's collateral as of the petition date.
- The court should not approve any proposed adequate protection under section 361 that grants a lien on, or any direct or indirect interest in (including through a superpriority claim), the estate's avoidance actions or the proceeds of such actions under chapter 5 of the Bankruptcy Code. Nevertheless, this prohibition should not limit the proceeds available to satisfy a prepetition secured creditor's claim arising solely under section 507(b).

Terms of Postpetition Financing

Recommended Principles:

- A court should not approve any proposed postpetition financing under section 364 of the Bankruptcy Code that contains a provision to roll up prepetition debt into the postpetition facility or to pay down prepetition debt in part or in full with proceeds of the postpetition facility. This provision should not apply to postpetition financing, including a facility that refinances in part or in full prepetition debt, to the extent that —

- the postpetition facility (a) is provided by lenders who do not directly or indirectly through their affiliates hold prepetition debt affected by the facility or (b) repays the prepetition facility in cash, extends substantial new credit to the debtor, and provides more financing on better terms than alternative facilities offered to the debtor; and
- the court finds that the proposed postpetition financing is in the best interests of the estate.

- A court should not approve any proposed postpetition financing under section 364 that grants a lien on, or any interest in (including through a superpriority claim), the estate's avoidance actions or the proceeds of such actions under chapter 5 of the Bankruptcy Code.
- Subject to a 60-day restriction on milestones, benchmarks, and similar provisions (*see* Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions*), a court should be able to approve, in a final order, permissible extraordinary financing provisions in connection with any proposed postpetition financing under section 364. For the definition of "permissible extraordinary financing provisions," see Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions.*
- Any prepetition contractual prohibition on subordinated prepetition junior secured creditors offering or providing postpetition financing to the debtor should not be enforced in the chapter 11 case, provided that: (i) any such subordinated prepetition junior secured creditors should not be permitted to prime the perfected security interests of the prepetition senior secured creditors with the postpetition financing facility; and (ii) if the court approves the postpetition financing facility offered by the subordinated prepetition junior secured creditors, the prepetition senior secured creditors should have the option to match the terms of, and to provide the financing facility in lieu of, the subordinated junior secured creditors within a reasonable time as specified in the court's interim order approving the postpetition financing. These provisions would render unenforceable any contractual damages provisions that would otherwise allow prepetition senior secured creditors to recover damages for breach of contract against subordinated prepetition junior secured creditors under nonbankruptcy law based on the provision of postpetition financing. Sections 364 and 510 should be amended accordingly.

Definition of SME

Recommended Principles:

- For purposes of these principles, the term "***small or medium-sized enterprise***" ("***SME***") means a business debtor with —

(i) No publicly traded securities in its capital structure or in the capital structure of any affiliated debtors whose cases are jointly administered with the debtor's case; and

(ii) Less than $10 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates as of the petition date.

A debtor purporting to qualify as an SME under this definition must file a balance sheet reflecting a good faith estimate of its assets and liabilities as of the petition date with its chapter 11 petition.

- The court *sua sponte*, the U.S. Trustee, or a party in interest should be able to object to the debtor's indication in the petition that it satisfies subsections (i) and (ii) above and qualifies as an SME, but only on the grounds that the debtor does not in fact meet the definition of SME under the Bankruptcy Code. Such objection should be filed on or before 14 days after notice of the debtor's indication in the petition that it qualifies as an SME, and it should be heard on an expedited basis.
- In addition, if a business debtor satisfies subsection (i) above and has more than $10 million but less than $50 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates, the debtor may file a motion seeking to be treated as an SME in its chapter 11 case. Such motion must be filed with the debtor's voluntary petition or within seven days after the entry of the order for relief in an involuntary case. The court should grant such motion and classify the debtor as an SME only if the motion is timely filed and the court determines based on evidence presented at the hearing that treating the debtor as an SME in the chapter 11 case is in the best interest of the estate. Any objection to such motion should be filed on or before 14 days after the filing of the motion, and the motion and any objections should be heard on an expedited basis.
- The definition of SME does not include a "single asset real estate" case as defined in section 101(51B) of the Bankruptcy Code.
- The "***small business case***" and "***small business debtor***" provisions of the Bankruptcy Code should be deleted in their entirety.

General Application of SME Principles

Recommended Principles:

- A debtor that satisfies the definition of an SME should be subject to the principles set forth herein for SME cases without further action by the court, trustee, or debtor in possession.
- If an objection is timely filed to the debtor's indication in the petition that it qualifies

as an SME under the Bankruptcy Code definition, such debtor should be treated as an SME unless and until the entry of an order of the court sustaining any such objection.

- If a debtor timely files a motion seeking to be treated as an SME, such debtor should be treated as an SME only upon the entry of an order of the court overruling any objections thereto and authorizing the debtor's designation as an SME.
- If a debtor qualifies or is designated as an SME, the court may for cause, after notice and a hearing, permit the SME debtor to use good faith estimates in compiling its valuation information package, as required by the principles, if audited or unaudited financial statements are not readily available. The court also may set a deadline by which the SME debtor should turn over its valuation information package, to a requesting party in interest. *See* Section IV.A.6, *Valuation Information Packages*.
- The general recommended principles proposed for chapter 11 cases apply to SME cases, unless the principles expressly exclude SME cases or would otherwise conflict with the SME principles.

Oversight of SME Cases

Recommended Principles:

- The debtor should be permitted to operate as a debtor in possession with all rights, powers, and duties set forth in section 1107 of the Bankruptcy Code and subject to the appointment of a chapter 11 trustee for cause under section 1104.
- A committee of unsecured creditors under section 1102(a) should not be appointed in an SME case unless an unsecured creditor or the U.S. Trustee files a motion with the court requesting the appointment of a committee and the court, after notice and a hearing, determines that the appointment is necessary to protect the interests of unsecured creditors in the case.
- If the debtor does not satisfy the Bankruptcy Code definition of SME but files a timely motion to be treated as an SME in the chapter 11 case, the U.S. Trustee should not appoint a committee of unsecured creditors unless the court denies the debtor's motion. The U.S. Trustee should suspend its ordinary appointment process pending resolution of the debtor's motion.
- If the debtor qualifies as an SME or is designated an SME by the court, the notice of the chapter 11 case served upon creditors should explain that the U.S. Trustee will not appoint a committee of unsecured creditors in the case unless such committee is requested by an unsecured creditor or the U.S. Trustee and the court orders such appointment. If the debtor indicates in its petition that it qualifies as an SME, such notice also should explain that parties in interest have 14 days from the date of such

notice to object to the debtor's treatment as an SME.

- The court *sua sponte*, the U.S. Trustee, the debtor in possession, or a party in interest should be able to request the appointment of an estate neutral that also has the authority to advise the debtor in possession on operational and financial matters, as well as the content and negotiation of its plan. The standard for approval of an estate neutral and the U.S. Trustee's authority to appoint the estate neutral, if ordered by the court, should be governed by the general principles on estate neutrals. *See* Section IV.A.3, *The Estate Neutral*.
- Any estate neutral should represent the interests of the estate and be paid by the estate. The Bankruptcy Code could establish a fee structure available for the estate neutral in an SME case to control costs and increase certainty. Such structure could be based on the size of the case or the amount of creditor distributions.

Plan Timeline in SME Cases

Recommended Principles:

- Within 60 days of the entry of the order for relief, the SME debtor should develop and file with the court a timeline for filing and soliciting acceptances of its plan.
- If an estate neutral or a committee is appointed, the SME debtor should consult with such estate neutral or committee in developing its timeline.
- After the SME debtor files its timeline for filing and soliciting acceptances of its plan, the court should enter an order under section 105(d)(2)(B) setting the deadlines for the SME debtor's plan process.
- The SME debtor should be subject to the exclusivity periods provided in section 1121.

Plan Content and Confirmation in SME Cases

Recommended Principles:

- A chapter 11 plan in an SME case should provide for the following treatment of allowed claims and interests in the case:
    - Payment of all administrative and priority claims in accordance with

section 1129(a)(9) of the Bankruptcy Code.

- Bifurcation of each undersecured claim into an allowed secured claim in accordance with section 506 and a general unsecured claim for any deficiency claim; neither section 1111(b) nor section 1129(a)(7)(B) should apply in an SME case.
- Distributions to secured creditors (i) as provided in the plan and accepted by each class of secured creditors; or (ii) in accordance with section 1129(b)(2)(A).
- Distributions to unsecured creditors (i) as provided in the plan and accepted by each class of unsecured creditors; (ii) in accordance with section 1129(b)(2)(B) (subject to the recommended principles codifying the new value corollary); or (iii) as provided below for an ***SME Equity Retention Plan***. *See* Section VI.C.2, *New Value Corollary*.
- Prepetition equity interests may receive voting common stock or ownership units in the reorganized debtor, provided that (i) all impaired classes have accepted the plan; (ii) the plan complies with section 1129(b) (subject to the recommended principles codifying the new value corollary); or (iii) the plan complies with section 1129(b)(2)(A) and provides impaired classes of unsecured creditors that have rejected the plan with preferred stock, or similar economic interests, in the reorganized debtor as described below (an "***SME Equity Retention Plan***").

- The court should confirm an SME Equity Retention Plan that is not accepted by any class of unsecured claims only if:
  - (i) The prepetition equity security holders will continue to support the debtor's successful emergence from chapter 11 by remaining involved, on a basis reasonably comparable to their prepetition involvement, in the ongoing operations of the reorganized debtor; and (ii) the reorganized debtor will pay to the holders of unsecured claims, no less often than annually, its excess cash flow calculated in a manner reasonable in relation to the company's operating cash flow for each of the three full fiscal years following the effective date of the chapter 11 plan. The debtor should file a budget with its disclosure statement and chapter 11 plan that describes the excess cash flow calculation method and includes projections of excess cash flow for the three fiscal years following the effective date of the plan.
  - The prepetition equity security holders receive or retain 100 percent of the common stock, or similar ownership interests, issued or outstanding as of the effective date entitling the holders as a class to receive 15 percent of any economic distributions from the reorganized debtor, including dividends, liquidation or sale proceeds, merger or acquisition consideration, or other consideration distributed to the economic owners of the reorganized debtor.
  - The prepetition unsecured creditors as a class receive 100 percent of a class of preferred stock, similar preferred interests, or payment obligations issued by

the reorganized debtor on the effective date in accordance with the chapter 11 plan with the following features (referred to as the "***creditors' preferred interests***"): (i) *pro rata* voting rights, limited to voting only on the extraordinary transactions identified in these principles; and (ii) entitlement as a class to receive 85 percent of any economic distributions from the reorganized debtor, including dividends, liquidation or sale proceeds, merger or acquisition consideration, or other consideration distributed to the economic owners of the reorganized debtor.

- The creditors' preferred interests mature on the fourth anniversary of the effective date, at which time the interests should convert into 85 percent of the common stock, or similar ownership interests, of the reorganized debtor, unless redeemed in cash on or before the maturity date for their full face amount. The face amount of the creditors' preferred interests should equal the amount of the allowed unsecured claims held by those creditors receiving the creditors' preferred interests and established under the plan or confirmation order. Any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to the maturity date should reduce the redemption or conversion value of such interests.
- The following kinds of post-effective date transactions are deemed "***extraordinary transactions***" subject to the vote of holders of creditors' preferred interests: (i) any change to the compensation of, or payments to, insiders of the reorganized debtor as set forth in the chapter 11 plan, including any compensation or payments to or for the benefit of relatives or affiliates of such insiders; (ii) dividends or other distributions of value to equity security holders of the reorganized debtor; (iii) decisions to forego or roll over any dividends or other distributions of value required to be paid under the organizational documents on account of the economic ownership interests held by holders of creditors' preferred interests; (iv) the sale of all or substantially all of the assets of the reorganized debtor, dissolution of the reorganized debtor, or merger of the reorganized debtor with or its acquisition of another entity; and (v) any amendments to the organizational documents that would modify, alter, or otherwise affect the rights of holders of creditors' preferred interests. An extraordinary transaction should require at least an absolute majority vote of the holders of creditors' preferred interest, but the chapter 11 plan may require a higher level of approval. Whether an extraordinary transaction has been approved by the requisite majority vote (or such higher level as required by the plan) should be determined in accordance with applicable state entity governance law.
- The consummation of an extraordinary transaction without the requisite approval should constitute a default under the chapter 11 plan, and holders of creditors' preferred interests should have the ability to request appropriate relief for such breach from the court that confirmed the plan. In addition, upon any such default, the creditors' preferred interests should be entitled to a liquidation preference over the common stock in the full face amount of the

creditors' preferred interests, reduced by any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to liquidation.

- The general recommended principles proposed for chapter 11 plans apply to SME cases, unless the principles expressly exclude SME cases or would otherwise conflict with the SME principles.