Paid in Full in Bankruptcy and the Unwary Creditor

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We've all heard it said a million times - if it sounds too good to be true, it probably is. But does that age-old maxim apply to a bankrupt customer offering to pay you 100% of your unsecured claim through a "prepackaged" bankruptcy or under a critical vendor program? The answer can be complicated.

This article explores what it means to be "unimpaired" and paid in full in prepackaged bankruptcies and under critical vendor programs and outlines some of the potential pitfalls that can be faced by unsecured creditors under these scenarios.

In a prepackaged bankruptcy, a debtor's goal is to avoid all obstacles to a speedy exit from Chapter 11. To achieve this goal, a debtor will often promise to pay unsecured creditors 100% of their prepetition claims in the ordinary course of business. The debtor is then able to represent to the bankruptcy court that unsecured creditors' rights are "unimpaired." This designation deprives unsecured creditors of the right to vote on the plan because, according to the debtor, their claims pass through the bankruptcy fully intact. Given the speed of prepackaged bankruptcies, a debtor typically does not file schedules setting forth the nature, extent, and the amount of creditors' prepetition claims. Also, there is no bar date for creditors to file proofs of claim or process to reconcile claims when the amount of a claim is in dispute.

Another way debtors "unimpair" creditors' claims in many jurisdictions is to deem certain vendors and service providers "critical" to the debtor's business. This designation allows debtors to obtain court authorization to pay critical vendors' general unsecured claims during the course of the bankruptcy case. This is an attractive proposition for eligible unsecured creditors, particularly in those cases where such creditors are slated to receive little or no recovery. Critical vendor programs typically condition full payment of claims upon entry into an agreement with the debtor. The agreement generally establishes the allowed amount of the creditors' prepetition claim, often in a reduced amount, in exchange for the promise of payment either in a lump sum or through a series of installments over time. Payment is conditioned on abiding by the agreed terms, which may be more favorable to the debtor than the prepetition terms may present an increased risk of nonpayment for the creditor due to the inherent uncertainties of Chapter 11.

Whether a creditor is to be paid in full under a prepackaged plan or a critical vendor program, the debtor and its general unsecured creditors may not be aligned on the amount or the timing of payment before the plan is confirmed. In practice, claims initially designated for payment in full often remain unpaid, disputed, and subject to further negotiation and possible litigation even after the plan has been confirmed. At the same time, the plan usually requires creditors to give broad releases to the debtor and third parties, eliminates rights of setoff and recoupment, and waives creditors' rights to have disputes resolved by the bankruptcy court. All too often, these important rights are waived before creditors receive payment of their claims.

Adding to the potential pitfalls for unsecured creditors, a creditors' committee may not be appointed because unsecured creditors mistakenly assume that they will be paid in full on a timely basis and that their rights will otherwise be unaffected by the bankruptcy. Without a creditors' committee, the opportunity for creditors to effectively evaluate and, if necessary, challenge prejudicial prepackaged plan provisions and negotiate mutually beneficial critical vendor agreements are limited. Perhaps more importantly, the absence of a creditors' committee deprives unsecured creditors of a meaningful opportunity to fully evaluate whether the debtor has the financial wherewithal to make the promised payments and to honor trade terms on a go-forward basis after plan confirmation. Failure to properly test the assumptions underlying the debtor's financial projections and business plan may leave unsecured creditors in a worse off position once the plan has been confirmed.

Prepackaged Bankruptcies

In a prepacked bankruptcy, the debtor typically offers a full recovery to unsecured creditors, restructures its balance sheet, and expeditiously exits bankruptcy. The term prepackaged bankruptcy generally describes a bankruptcy case where the plan is negotiated and voted upon by certain key players, typically the debtor's lenders, prior to the bankruptcy filing. At the time of the filing, each of the different classes of the debtor's creditors under the plan have either consented to the treatment of their claims under the plan or have had their claims deemed unimpaired. This strategy allows the debtor to file the plan and accompanying disclosure statement on or around the petition date and exit bankruptcy in a matter of weeks as opposed to months or even years.

Having secured the consent of its lenders to the plan prior to the bankruptcy filing, the success of this expedited timeline often turns on the debtor's ability to have the bankruptcy court agree that certain classes of the debtor's creditors are unimpaired. Impairment is a term defined by the Bankruptcy Code that describes a creditor's treatment under a bankruptcy plan. Specifically, each creditor has legal, equitable, or contractual rights that are subject to modification under the plan. If a creditor's rights are modified, the creditor's claim is impaired, and the creditor is entitled to vote in favor of or against the plan. Depending on the number of dissenting creditors in a given class of impaired claims, there may be sufficient "no" votes to deny confirmation of the plan. Creditors whose rights are not modified by the plan are unimpaired, are not entitled to vote, and may never receive a copy or even notice of the plan.

In sum, if each class of the debtor's creditors under a prepackaged plan have consented to, or are unimpaired under, the plan, the debtor is spared the lengthy and expensive process of soliciting and tabulating votes that could ultimately result in substantial delay or even denial of plan confirmation.

Is Your Claim Impaired?

While payment in full sounds promising, general unsecured creditors often find themselves left to negotiate or even litigate the amount and timing of payment of their claims both during the plan process and after the plan is confirmed. In a typical prepackaged bankruptcy, the debtor will represent that claims of general unsecured creditors are unimpaired because they will be paid in full on the later of (i) the effective date of the plan, or (ii) the date payment is due to be made to the creditor in the "ordinary course of business."

As a practical matter, on the plan's effective date, the debtor and its creditors may not be in agreement on the amount or timing of payment of the creditors' claims. A creditor may believe it is entitled to more than the debtor anticipates paying. This situation arises because the debtor does not file schedules of its liabilities or otherwise disclose the amounts owed to unsecured creditors and creditors do not file proofs of claim. As such, there is little or no visibility into the amount the debtor or the creditor believe is the correct amount due and owing before the plan goes effective. The parties may also have a different understanding of the timeline for payment based on their respective interpretations of what is meant by the phrase payment in the ordinary course of business. The ambiguity surrounding the timing and amount of payment is compounded by the fact that these purportedly unimpaired creditors may not receive a copy or even notice of the prepackaged plan.

In addition to the uncertainty surrounding the amount and timing of payment, prepackaged plans commonly modify unsecured creditors' rights, arguably impairing them in even more troubling ways as follows:

- Eliminate or limit setoff and recoupment rights;
- Grant broad releases of past, present, and future claims against the debtor and third parties; and
- Exclude certain claims from payment in full.

<u>Setoff and Recoupment</u>: When reconciling claims with the debtor, it is important for creditors to retain rights of setoff and recoupment. Prepackaged plans often waive these rights or require creditors to obtain relief from the court or to comply with onerous procedures prior to exercising such rights. At the same time, the plan fully preserves the debtor's rights of setoff and recoupment.

Releases: Creditors may be forced to release all past, present, and future claims against the debtor and other parties. If a dispute arises after the effective date, creditors may realize their rights to pursue their remedies against the debtors, guarantors, or other third parties have been waived or compromised under the plan.

Exclusion From Payment: Whether an unsecured creditor's claim is truly entitled to payment in full turns on whether the claim is designated an "allowed" claim under the plan. The definition of allowed can vary dramatically from case to case and involve confusing and contradictory use of the words "allowed" and "disputed." This gives the debtor broad discretion to determine which claims are allowed and truly paid in full and, at a minimum, leverage in negotiating the actual amount to be paid.[1]

What is meant by payment in full in the ordinary course of business, together with the waiver of rights and other provisions under a prepackaged plan, can be used against unsecured creditors to effectively impair a creditor's rights despite the classification of the creditor's claim as unimpaired.

Without active involvement and vigilance by unsecured creditors, important rights can be lost before claims are paid. Faced with limited resources and expedited timetables, individual unsecured creditors often are ill prepared to properly preserve and protect their rights. A creditors' committee is best suited to identify and address these issues on behalf of all unsecured creditors. A creditors' committee can insist on provisions that provide clarity and transparency as to the timing and amount of payment and, if necessary, dispute resolution procedures. A creditors' committee can also advocate for the debtor to file schedules or make other disclosures detailing the amount of unsecured claims so that creditors may resolve discrepancies before the plan is confirmed. If the committee determines that plan provisions are unduly prejudicial to unsecured creditors or the debtor is unable to meet its financial obligations under the plan, the creditors' committee can file an objection with the bankruptcy court.

Critical Vendor Programs

In addition to classifying unsecured claims as unimpaired, debtors can effectively unimpair the claims of certain vendors and service providers by promising them payment in full under a critical vendor program. Critical vendor programs present creditors with the proverbial carrot and the stick. The debtor wants or needs a creditor's goods or services, and to induce a creditor to continue doing business, the debtor will condition full payment of the creditor's prepetition claims upon terms embodied in an agreement. Faced with the prospect of little or no recovery and the loss of future business, the creditor wants to be paid for the work or goods it provided prepetition and values the prospect of a go-forward customer.

While the form of agreement is negotiable and varies from case to case, to receive payment, a creditor is usually required to prove its prepetition claim and to agree to reduce its claim. Payment of the reduced claim can be in a lump sum, multiple installments, or in the ordinary course of business. Creditors must agree to continue to provide goods or services to the debtor on terms, which may be more onerous than the prebankruptcy terms and may present an increased risk of nonpayment due to the uncertainties of Chapter 11. The agreement will often prohibit creditors from filing liens, limit or restrict remedies, and may require the creditor to vote in favor of a plan it has not even seen. The agreement may also leave the creditor exposed to liability for payments received by the creditor in the 90 days prior to the bankruptcy filing and limit the creditor's right to terminate the agreement in the event of nonpayment.

Once again, individual creditors must be vigilant and, if appointed, a creditors' committee will be able to negotiate a form of agreement that benefits the entire creditor body. With the benefit of a creditors' committee's input, unsecured creditors' carrot and stick conundrum becomes far more manageable as the risk of nonpayment and bankruptcy-related liabilities for critical vendors and servicers can be mitigated.

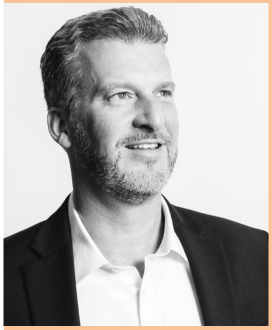
Conclusion

Regardless of the debtor's assurance that –payment in full equates to unimpairment of unsecured creditors' valuable rights and claims, creditors should carefully scrutinize prepackaged plans and critical vendor agreements and stay informed throughout the process to protect their interests. Unfortunately, a debtor's promise to pay unsecured creditors' claims in full is not as simple and straight forward as it sounds. Prepackaged plans and critical vendor agreements routinely

1 For example, the definition of allowed often deems a claim "disputed" if a creditor files a proof of claim. Once a claim is identified by the debtor as "disputed," the plan allows the debtor to refuse to pay the claim.

modify creditors' rights and introduce a risk of nonpayment that did not exist prior to the bankruptcy filing. A creditors' committee can play a key role in providing creditors with guidance and insight into the debtor's willingness and ability to satisfy unsecured claims and meet its go-forward financial obligations once the plan has been confirmed.

About the Authors:



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