BANKRUPTCY 101

Christopher M. López
Weil, Gotshal & Manges LLP
700 Louisiana Street, Suite 1600
Houston, Texas 77002
chris.lopez@weil.com
(713) 546-5000 telephone
(713) 224-9511 facsimile

State Bar of Texas
Essentials of Business Law
March 7, 2014
Houston, Texas

Christopher M. López

Counsel, Houston
chris.lopez@weil.com
700 Louisiana, Suite 1600
Houston, TX 77002-2784
Tel +1 713 546 5166
Fax +1 713 224 9511

Christopher López is a counsel in the Business, Finance & Restructuring Department of Weil, Gotshal & Manges' Houston office. He has practiced in the areas of business reorganization and insolvency since 2003.

Mr. López has been involved in a number of significant chapter 11 cases including AMR Corporation/American Airlines, Inc., WorldCom, Inc., Enron Corp., Global Crossing Limited, SemGroup, L.P., General Growth Properties, Inc., Express Energy Services, L.P., and International Aluminum Corp.

Mr. López graduated from the University of Houston with a B.A. in psychology in 1996. He received his M.A. from Yale in 1999. In 2003, he received his J.D., with honors, from the University of Texas School of Law, where he was a member of the Texas International Law Journal and elected permanent class president for the class of 2003.

Mr. López is a member of the State Bar of Texas and the Houston Bar Association. He is admitted to practice before the United States District Court for the Southern District of Texas, Northern District of Texas and the Western District of Texas. Mr. López is a member of the Honorable Arthur L. Moller/David B. Foltz, Jr. American Inn of Court. In addition, he has studied cross-border and banking issues in Mexico. He has also been named a Rising Star by *Texas Monthly* magazine between 2010-2013.

Mr. López is a member of the board of directors of the Hispanic Bar Association of Houston.

Education

University of Texas School of Law (J.D., 2003)

Yale University (M.A., 1999)

University of Houston (B.A., 1996)

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I. INTRODUCTION

The United States Constitution grants Congress the power to establish "uniform laws on the subject of bankruptcies throughout the United States." U.S. Const., Art. 1, § 8, cl. 4. Federal bankruptcy laws are codified under title 11 of the United States Code, which is commonly referred to as the "Bankruptcy Code." Congress's stated goal of enacting the Bankruptcy Code was (i) equality of distribution among creditors and (ii) orderly rehabilitation or liquidation. H.R. Rep. No. 95-595, 95th Cong., 1st. Sess. 16, 177-78, 220 (1977).

Chapters 1, 3 and 5 of the Bankruptcy Code contain general laws that are applicable in any bankruptcy case. For example, section 101 of the Bankruptcy Code contains definitions and general rules of construction for the Bankruptcy Code, grants federal courts with broad equitable authority to issue any order, process, or judgment that is "necessary or appropriate to carry out the provisions" of the Bankruptcy Code, governs waivers of sovereign immunity, and covers the eligibility requirements to be a debtor. Chapter 3 contains sections governing a debtor's use, sale, or lease of property during the administration of a bankruptcy case, governs treatment of executory contracts and unexpired leases, provides standards for hiring and compensating professionals, implements an automatic stay upon the commencement of a bankruptcy case, and regulates a debtor's ability to incur debt during the course of a bankruptcy case. Chapter 5 contains sections governing the rights of creditors and their claims, defining what constitutes property of a debtor's estate, and granting powers to avoid fraudulent transfers and preferential transfers.

The Bankruptcy Code is also comprised of several chapters that govern the administration of distinct types of bankruptcy cases, such as chapter 7 (liquidation), chapter 9 (adjustment of debts of a municipality), chapter 11 (reorganization), chapter 12 (adjustment of debts of a family farmer or fisherman with regular annual income), and chapter 15 (recognition of a foreign proceeding).

This paper provides a general overview of important substantive and procedural aspects of bankruptcy cases filed under chapter 7 and chapter 11 of the Bankruptcy Code.

II. JURISDICTION

A federal district court's subject matter jurisdiction over a bankruptcy case is derived from 28 U.S.C. § 1334. Section 1334(a) grants district courts original and exclusive jurisdiction over all cases under the Bankruptcy Code. Section 1334(b) grants original, but not exclusive, jurisdiction to district courts over three types of civil proceedings: proceedings "arising under" the Bankruptcy Code, and proceedings "arising in" or "related to" cases under the Bankruptcy Code. 28 U.S.C. § 1334(b).

28 U.S.C. § 157(a), in turn, states that a district court may provide that any or all cases under the Bankruptcy Code and any or all proceedings arising under the Bankruptcy Code or arising in or related to a case under the Bankruptcy Code shall be referred to the bankruptcy judges for the district. Most district courts have a standing "reference order" providing that all bankruptcy cases in that district are, in the first instance, referred to bankruptcy judges.

28 U.S.C. § 157(b) provides that bankruptcy courts may hear and determine all cases under the Bankruptcy Code, and all *core proceedings* arising under the Bankruptcy Code or arising in a bankruptcy case.

28 U.S.C. § 157(b) further provides that core proceedings include, but are not limited to:

1. matters concerning the administration of the estate;

2. allowance or disallowance of claims against the estate or exemptions from property of the estate;

3. counterclaims by the estate against persons filing claims against the estate;

4. orders in respect to obtaining credit;

5. orders to turn over property of the estate;

6. motions to terminate, annul, or modify the automatic stay;

7. determinations as to the dischargeability of particular debts; and

8. confirmation of plans.

Bankruptcy courts may enter final judgments in core proceedings. In non-core proceedings, bankruptcy courts may only enter proposed findings of fact and conclusions on law, which must be reviewed by a district court.

III. GENERAL OVEREVIEW OF "STERN" CONSTITUTIONAL ISSUES

On June 23, 2011, the U.S. Supreme Court issued its decision in *Stern v. Marshall*, 131 S. Ct. 2594 (2011), which held that a bankruptcy court could not constitutionally enter a final judgment on a debtor's state law counterclaim against a creditor, despite statutory authority under 28 U.S.C. § 157(b) to do so as an express "core proceeding." Instead, on such counterclaims, a final judgment may only be entered by an Article III district court.

Article III, § 1 of the Constitution defines the judicial power of the United States and prescribes that federal judges have important salary and tenure protections designed to prevent the legislative and executive branches of the U.S. government from encroaching on the judicial power of federal courts. U.S. Const. Art. III, § 1. Bankruptcy judges, however, are appointed pursuant to Article I of the U.S. Constitution, which confers on the Congress the power to "establish uniform laws on the subject of bankruptcies throughout the United States," and, thus, do not enjoy the constitutional protections afforded to Article III judges. U.S. Const. Art. I, § 8.

The broadest interpretation of *Stern* suggests that because bankruptcy courts are not "Article III" courts, Congress cannot pass laws granting bankruptcy court authority over any matters that are either not (i) inherent squarely within the Bankruptcy Code, such as avoiding a preferential transfer pursuant to section 547 of the Bankruptcy Code, or (ii) resolved in ruling on a claim against the debtor, such as resolving a state law issue that must be addressed in connection with liquidating a proof of claim filed by the creditor against a debtor.

Following *Stern*, federal circuit courts split over whether litigants could cure a constitutional deficiency through consent – in other words, whether bankruptcy courts could enter a final judgment on *Stern* type matters if the parties consented to such a resolution or whether consent could be implied from the parties' conduct. *Compare Waldman v. Stone*, 698 F.3d 910 (6th Cir. 2012) (parties cannot consent to final adjudication of matters if the bankruptcy court lacks constitutional authority to enter a final judgment); *Wellness Int'l Network v. Sharif*, No. 12-1349, 2013 WL 4441926 (7th Cir. Aug. 21, 2013) (same) and *Exec. Benefits Ins. Agency v. Arkinson (In re Bellingham Ins. Agency, Inc.)*, 702 F.3d 553 (9th Cir. 2012) (holding that bankruptcy judges lack constitutional authority to enter final judgments on fraudulent transfer actions against third parties that are not claimants in the debtor's bankruptcy case, but a failure to challenge the bankruptcy court's authority at an earlier stage in the proceedings may constitute implied consent to final adjudication before the bankruptcy court).

In a recent decision, *In re Frazin*, No. 11-10403, 2013 WL 5495920 (5th Cir. Oct. 1, 2013), the Fifth Circuit Court of Appeals, in a footnote, sided with the Sixth and Seventh Circuits and against the Ninth Circuit and stated that a private party's consent or waiver cannot cure constitutional structural concerns implicated by a bankruptcy court's lack of constitutional authority to enter a final order on a state law counterclaim claim under *Stern*.

On June 24, 2013, the Supreme Court granted certiorari on the 9th Circuit *Bellingham* decision. Oral argument was heard on January 14, 2014. The questions presented by the petitioner to the Supreme Court were:

1. whether Article III permits the exercise of the judicial power of the United States by bankruptcy courts on the basis of litigant consent, and, if so, whether "implied consent" based on a litigant's conduct, where the statutory scheme provides the litigant no notice that its consent is required, is sufficient to satisfy Article III; and

2. whether a bankruptcy judge may submit proposed findings of fact and conclusions of law for de novo review by a district court in a "core" proceeding under 28 U.S.C. 157(b).

IV. VENUE

28 U.S.C. § 1408 establishes the venue for bankruptcy cases and provides that, except for cases ancillary to foreign proceedings, bankruptcy cases may be filed in the district court for the district—

1. in which the domicile, residence, principal place of business in the United States, or principal assets in the United States, of the person or entity that is the subject of such case have been located for the one hundred and eighty days immediately preceding such commencement, or for a longer portion of such one-hundred-and-eighty-day period than the domicile, residence, or principal place of business, in

the United States, or principal assets in the United States, of such person were located in any other district; or

2. in which there is a pending case under the Bankruptcy Code concerning such person's affiliate, general partner, or partnership.

For corporate debtors, "domicile" is generally determined by the state of incorporation. *See, e.g., In re KT Spears Creek,* LLC, No. 11–33991–H3–11, 2011 WL 2580173 (Bankr. S.D. Tex. June 28, 2011). The phrase "principal place of business" refers to the place where a corporation's high level officers direct, control, and coordinate the corporation's activities, i.e., its "nerve center," which will typically be found at its corporate headquarters. *See In re Commonwealth Oil Ref. Co.,* 596 F.2d 1239 (5th Cir. 1979); *In re New Luxury Motors*, *LLC*, Nos. 10–30835, 2010 WL 817204 (Bankr. S.D. Tex. Mar. 4, 2010).

28 U.S.C. § 1408(2) provides another alternative for potential debtors with affiliates that have already filed for bankruptcy: A potential debtor may file in the district "in which there is pending a case under title 11 concerning such person's affiliate, general partner, or partnership." The application of section 1408(2), albeit proper, may result in motions to transfer venue "in the interest of justice or for the convenience of the parties" pursuant to 28 U.S.C. § 1412.

28 U.S.C. § 1412 provides that "[a] district court may transfer a case or proceeding under title 11 to a district court for another district, in the interest of justice or for the convenience of the parties." Section 1412 is phrased in the disjunctive; therefore, a transfer may be ordered based either on the interest of justice *or* for the convenience of the parties. The party seeking the transfer bears the burden of showing, by a preponderance of the evidence, that a transfer is warranted. *See, e.g., Norton v. Encompass Servs. Corp.*, 301 B.R. 836 (Bankr. S.D. Tex. 2003).

Courts have described the "interest of justice" prong as a broad and flexible standard that contemplates a consideration of whether transferring venue would promote the efficient administration of the bankruptcy estate, judicial economy, timeliness, and fairness. *See Zhang v. Rothrock,* No. Civ. A. H–05–3461, 2006 WL 213951 (S.D. Tex. Jan. 25, 2006); *In re BDRC Lofts*, *Ltd.*, No. 12-11559-CAG, 2013 WL 395129 (Bankr. W.D. Tex. Jan. 31, 2013).

The Fifth Circuit case *In re Commonwealth Oil Refining Co. (*"*Corco*"*)* set forth six factors courts consider when analyzing the "convenience of the parties" prong:

1. the proximity of creditors of every kind to the court;

2. the proximity of the bankrupt (debtor) to the court;

3. the proximity of the witnesses necessary to the administration of the estate;

4. the location of the assets;

5. the economic administration of the estate; and

6. the necessity for ancillary administration if bankruptcy should result.

Commonwealth of P.R. v. Commonwealth Oil Refining Co. (*In re Commonwealth Oil Refining Co.*), 596 F.2d 1239 (5th Cir. 1979), *cert. denied*, 444 U.S. 1045 (1980). Of the six *Corco* factors, "the most important consideration is whether the requested transfer would promote the economic and efficient administration of the estate." *Id.*, *see also, In re BDRC Lofts, Ltd.*, No. 12-11559-CAG, 2013 WL 395129 (citing *LSREF2 BARON, LLC v. Aguilar*, No. 3:12-cv-1242-M, 2013 WL 230381 (N.D. Tex. Jan. 18, 2013)). However, at least one bankruptcy court has held that *Corco* should not apply because it addressed the operative rule for transferring venue at that time, and not 28 U.S.C. § 1412. *See In re Victorville Aerospace, LLC*, Nos. 08–35790, 08–35785, 2008 WL 5482785 (citing *In re Volkswagen of Am., Inc.,* 545 F.3d 304 (5th Cir. 2008)). Instead, the *Victorville* court considered private and public interest factors when determining whether to transfer venue for the convenience of the parties or in the interest of justice. *Id.*

The private interest factors considered were:

1. the relative ease of access to sources of proof;

2. the availability of compulsory process to secure the attendance of witnesses;

3. the cost of attendance for willing witnesses; and

4. all other practical problems that make trial of a case easy, expeditious and inexpensive.

The public interest factors considered were:

1. the administrative difficulties flowing from court congestion;

2. the local interest in having localized interests decided at home;

3. the familiarity of the forum with the law that will govern the case; and

4. the avoidance of unnecessary problems of conflict of laws [or in] the application of foreign law. *Id.*

V. ELIGIBILITY TO BE A DEBTOR

Section 109(a) of the Bankruptcy Code governs eligibility to be a debtor under the Bankruptcy Code. A debtor is eligible to file under chapter 7 if it is a "person" that resides or has a domicile, a place of business, or property in the United States, except for a railroad, a domestic insurance company, savings bank, cooperative bank, savings and loan association, etc. 11 U.S.C. §§ 109(a), (b). For chapter 11, a debtor may be a railroad, a person eligible under chapter 7, except a stockbroker, commodity broker, or nonbusiness trust. *Id.* at § 109(d). The term "person" is defined under section 101(41) of the Bankruptcy Code to include an "individual, partnership, and corporation," but specifically excludes "governmental units." A "governmental unit" is defined as: "United States; State; Commonwealth; District: Territory; municipality; foreign state; department, agency, or instrumentality of the United States…, a State, a Commonwealth, a District, a Territory, a municipality, or a foreign state; or other foreign or domestic government." *Id.* at § 101(27).

A debtor filing a case under chapter 7 or chapter 11 need not demonstrate that it is insolvent. While not the subject of this paper, it is important to note that an individual debtor (i.e., a human being) filing a chapter 7 liquidation case must also satisfy income requirements commonly referred to as the "means test" under section 707(b) of the Bankruptcy Code.

VI. INVOLUNTARY BANKRUPTCY CASES

Pursuant to section 303 of the Bankruptcy Code, an involuntary bankruptcy case may be commenced against a "person," except a farmer, family farmer, or a charitable institution, under chapter 7 or chapter 11 of the Bankruptcy Code. 11 U.S.C. § 303(a). A petition to commence an involuntary case may be filed by, among others:

1. three or more entities holding undisputed non-contingent claims totaling at least $15,325;

2. one creditor holding an undisputed non-contingent claim totaling at least $15,325 (excluding any insiders of the debtor or a transferee of an avoidance transfer), if the debtor has less than 12 creditors holding undisputed non-contingent claims; or

3. fewer than all the general partners, if the debtor is a partnership. *Id.* at § 303(b).

Once an involuntary case is filed, the clerk of the bankruptcy court issues a summons for service on the debtor. Rule 1011 of the Federal Rules of Bankruptcy Procedure permits a debtor, or a general partner in a partnership debtor that did not join in filing the petition, 21 days after service of the summons to respond. Fed. R. Bankr. P. 1011(b). If no response is filed within the 21-day period, the bankruptcy court will enter an order for the relief requested in the involuntary petition. *Id.* at 1013(b). If the debtor challenges the involuntary petition, the court will conduct a trial and grant the relief requested in the petition only if:

1. the debtor is generally not paying its debts as they become due, unless such debts are the subject of a bona fide dispute as to liability or amount; or

2. within 120 days before the filing of the involuntary petition a custodian, other than a trustee, receiver, or agent appointed or authorized to take charge of less than substantially all of the property of the debtor for the purpose of enforcing a lien against such property, was appointed or took possession. 11 U.S.C. § 303(h).

VII. PROPERTY OF THE ESTATE

The commencement of a voluntary or involuntary case under chapter 7 or chapter 11 creates an estate that includes all the debtor's legal or equitable interests in property, both tangible and intangible, wherever located and by whomever held, as of the commencement of a case. 11 U.S.C. § 541(a); *United States v. Whiting Pools, Inc.*, 462 U.S. 198 (1983). In general, the estate acquires no greater interest in property than that held by the debtor as of the commencement of the case. Property of the estate includes property recovered by the debtor from third parties under avoiding powers granted under chapter 5 of the Bankruptcy Code, proceeds, products, rents, or profits derived from property of the estate, property acquired by the debtor within 180 days after the commencement of a case, and all claims or causes of action owned by the debtor as of the commencement of a bankruptcy case. 11 U.S.C. § 541(a).

VIII. AUTOMATIC STAY

One of the most important benefits a debtor and its creditors receive from a bankruptcy filing is the effect of the automatic stay under section 362 of the Bankruptcy Code. Pursuant to section 362(a), filing a bankruptcy petition immediately stays almost all actions by creditors against the debtor and its property, thereby affording the debtor a "breathing spell" to organize its affairs and resolve its debts.

Pursuant to section 362(a), filing a voluntary petition operates as an automatic stay of the following acts:

1. the commencement or continuation of a judicial, administrative, or other proceeding that was or could have been brought before the commencement of the bankruptcy case;

2. the enforcement of a prepetition judgment against the debtor or property of the estate;

3. any act to obtain possession of property of the estate or of property from the estate, or to exercise control over property of the estate;

4. any act to create, perfect, or enforce any lien against property of the estate (except that the automatic stay does not apply to the perfection of mechanics', materialmen's and other similar liens so long as the mechanics or materialmen take the necessary actions within the timeframe provided for under applicable state law);

5. any act to create, perfect, or enforce against the debtor any lien that arose before the commencement of the bankruptcy case;

6. any act to collect, assess, or recover against the debtor any claim that arose before the commencement of the bankruptcy case;

7. the setoff of any debt owing to the debtor that arose before the commencement of the case against any claim against the debtor; and

8. the commencement or continuation of a proceeding before the United States Tax Court concerning a corporate debtor's tax liability for a taxable period the bankruptcy court may determine or concerning the tax liability of a debtor who is an individual for a taxable period ending before the commencement of a bankruptcy case.

Absent modification of the stay, the debtor is relieved of any obligation to comply with pending deadlines, discovery requests, trial dates, appeals, etc., and any effort by an opposing party to enforce compliance is a violation of the automatic stay. While section 362(k) of the Bankruptcy Code affords individual debtors with a private right of action for any willful violation of the automatic stay, courts address violations of the automatic stay against corporate debtors by exercising civil contempt powers under section 105(a) of the Bankruptcy Code. *See, e.g.*, *Milbank v. McGee (In re LATCL & F, Inc.)*, Nos. 3:99–CV–2953–R, 398–35100–HCA, 2001 WL 984912 (N.D. Tex. Aug. 14, 2001); *Sanchez v. Ameriquest Mortg. Co. (In re Sanchez)*, 372 B.R. 289 (Bankr. S.D. Tex. 2007).

The automatic stay generally does not preclude actions against non-debtor entities, such as guarantors, affiliates, employees, officers, and directors. A bankruptcy court, however, may enjoin actions against third parties in appropriate circumstances when necessary to avoid harassment and interference with the debtor's property, operations and reorganization. It is also important to note that section 362(b) of the Bankruptcy Code enumerates specific acts or situations where the automatic stay does not apply.

IX. AVOIDANCE POWERS

Among the most powerful tools granted to a debtor are the avoiding powers under sections 544, 547, and 548 of the Bankruptcy Code. A debtor's avoiding powers may be used to recover certain transfers of money or property, or the creation of liens, during the period prior to the filing of a bankruptcy petition.

Generally, avoiding powers relate to two types of transfers – preferential transfers and fraudulent transfers. Preferential transfers are transfers made by a debtor during the 90-day period (one year period with respect to "insiders" such as directors, officers, controlling shareholders, and affiliates) preceding the commencement of a bankruptcy case (a) which are on account of a preexisting obligation, (b) which are made while the debtor was insolvent (there is a rebuttable presumption of insolvency during the 90-day period), and (c) which transfer enables the creditor to recover more than it would have recovered if the transfer had not been made and the debtor was liquidated in a chapter 7 case. 11 U.S.C. § 547(b). The debtor must prove each element by a preponderance of the evidence. *See, e.g., In re Jaggers*, 48 B.R. 33 (Bankr. W.D. Tex. 1985).

A transfer may nevertheless be exempt from avoidance as a preference if a creditor proves by a preponderance of the evidence that the transfer at issue is covered under an enumerated exception under section 547(c) of the Bankruptcy Code. 11 U.S.C. § 547(c); *Gulf City Seafoods, Inc. v. Ludwig Shrimp Co.* (*In re Gulf City Seafoods*), 296 F.3d 363 (5th Cir. 2002); *In re Entringer Bakeries, Inc.*, 548 F.3d 344 (5th Cir. 2008). Six exceptions generally applicable to business cases are:

1. transfers intended by the parties to be substantially contemporaneous exchanges for new value that are, in fact, substantially contemporaneous exchanges;

2. payments of debt incurred by a debtor in the ordinary course of business that are (a) made in the ordinary course of business between the debtor and the creditor or (b) according to ordinary business terms;

3. an enabling loan (i.e., any loan which enables the debtor to acquire assets that serve as security for the loan);

4. transfers to or for the benefit of a creditor, to the extent that, after such transfer, such creditor gave new value to or for the benefit of the debtor;

5. floating liens on inventory having fluctuations before a debtor's bankruptcy petition date, unless there has been some net improvement in the position of the creditor's collateral at filing as compared to 90 days prior to filing; and

6. valid statutory liens that may not otherwise be avoided by a debtor pursuant to section 545 of the Bankruptcy Code. 11 U.S.C. §§ 547(c)(1)-(6).

Regarding fraudulent transfers, section 548(a)(1)(A) of the Bankruptcy Code authorizes the avoidance of transfers of interests in a debtor's property or obligations incurred by the debtor within two years prior to the petition date if the debtor voluntarily or involuntarily made such transfers or incurred such obligations with actual intent to hinder, delay, or defraud any entity to which the debtor was or became indebted on or after the date such transfer was made or such obligation was incurred.

In addition, section 548(a)(1)(B) of the Bankruptcy Code authorizes the avoidance of transfers of interests in a debtor's property or obligations incurred by the debtor within two years prior to the petition date if:

1. the debtor "received less than reasonably equivalent value in exchange for such transfer or obligation" and

2. the debtor either: (i) was insolvent on the date that such transfer was made or such obligation was incurred, or became insolvent as a result of such transfer or obligation; (ii) was engaged in a business or transaction, or was about to engage in a business or transaction, for which any property remaining with the debtor was an unreasonably small capital; or (iii) intended to incur, or believed that the debtor would incur, debts that would be beyond the debtor's ability to pay as such debts matured. *Id.* at § 548(a)(1)(B). The debtor bears the burden to satisfy these elements by a preponderance of the evidence. *See, e.g., In re IFS Fin. Corp.*, 669 F.3d 255 (5th Cir. 2012).

A debtor may also, under section 544 of the Bankruptcy Code, step into the shoes of a creditor of the debtor and, in the creditor's shoes, utilize state law fraudulent transfer law, which generally have a reach back period of 4-6 years, to avoid a fraudulent transfer. 11 U.S.C. § 544.

X. EXECUTORY CONTRACTS AND UNEXPIRED LEASES

"Executory Contract" is not a defined term in the Bankruptcy Code. The generally accepted definition of an executory contract is a contract under which the obligations of the debtor and the other party are so far unperformed that the failure of either party to perform would constitute a material breach excusing the performance of the other. V. Countryman, *Executory Contracts in Bankruptcy: Part I,* 57 MINN. L. REV. 439 (1974); *see also Matter of Murexco Petroleum, Inc.*, 15 F.3d 60 (5th Cir. 1994); *In re MPF Holding U.S. LLC*, 495 B.R. 303 (Bankr. S.D. Tex. 2013).

Section 365(d)(3) of the Bankruptcy Code requires a debtor to perform all obligations under unexpired leases of non-residential real property. 11 U.S.C. § 365(d)(3). Section 365(d)(4) of the Bankruptcy Code further provides that a debtor in a chapter 11 case has until the earlier of 120 days after filing for bankruptcy or the date of confirmation to assume or reject an unexpired lease of non-residential real property under which it is a lessee. *Id.* at § 365(d)(4). The bankruptcy court will only extend this period up to 90 days, unless the lessor agrees to a longer extension. *Id.* Thus, unless the lessor consents, the debtor has a maximum of 210 days to assume or reject an unexpired non-residential real property lease.

Additionally, section 365(d)(5) of the Bankruptcy Code requires a debtor to perform all obligations under an unexpired personal property lease first arising from or after 60 days after the petition date. *Id.* at § 365(d)(5).

In a chapter 7 case, if the chapter 7 trustee does not assume or reject an executory contract or unexpired lease of residential real property or personal property within 60 days after the commencement of a chapter 7 case, unless such time has been extended by the bankruptcy court, such executory contract or unexpired lease is deemed rejected as a matter of law. *Id.* at § 365(d)(1).

Rejection. Pursuant to section 365(a) of the Bankruptcy Code, a debtor, subject to court approval, may reject burdensome unexpired leases and executory contracts. 11 U.S.C. § 365(a). To be authorized to do so, a debtor must satisfy the business judgment test. *See Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303 (5th Cir. 1985); *In re Pilgrim's Pride Corp.*, 467 B.R. 871 (Bankr. N.D. Tex. 2012).

The rejection of an executory contract or unexpired lease constitutes a breach of that contract that relates back to the date immediately preceding the filing of the bankruptcy petition. 11 U.S.C. §§ 365(g), 502(g). Thus, absent security, the claim of the nondebtor party has the status of a holder of a pre-bankruptcy general unsecured claim. *Id.*

Section 502(b)(6) limits a lessor's rejection damage claim for non-residential real property to the greater of (i) one year's rent without acceleration or (ii) 15% of the rent for the remaining term of the lease, without acceleration, not to exceed three years' rent. The lessor may add to its damage claim all unpaid rent as of the earlier of (i) the petition date or (ii) the date the lessor repossessed or the tenant surrendered the property. *Id.* at § 502(b)(6).

Upon rejection of an employment contract, the employee's damage claim is limited to the compensation provided by the contract for one year, without acceleration, from the earlier of (i) the petition date or (ii) the date on which the employment was terminated, plus any unpaid compensation as of such date. *Id.* at § 502(b)(7).

Assumption. If a debtor decides to remain a party to a prepetition executory contract or unexpired lease, it may assume it and all obligations under such contract or lease. If there has been a default under the executory contract or unexpired lease, it must be "cured" or the debtor must provide adequate assurance of future performance, unless the default is in a real property lease and it arose from a failure to perform "non-monetary" obligations and the default is currently impossible to cure. 11 U.S.C. § 365(b). To determine if a debtor has provided adequate assurance of future performance, courts look to factual conditions, including "consider[ation of] whether the debtor's financial data indicated its ability to generate an income stream sufficient to meet its obligations, the general economic outlook in the debtor's industry, and the presence of a guarantee." *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303 (5th Cir. 1985); *see also In re Liljeberg Enters., Inc.*, 304 F.3d 410 (5th Cir. 2002).

Assumption and Assignment. Debtors often assume favorable contracts and unexpired leases with a view towards assigning them to a third party. A debtor may not, however, assign an executory contract or unexpired lease unless it first assumes it and the assignee provides adequate assurance of future performance. 11 U.S.C. § 365(f)(2). Any clause that provides for termination or modification of an executory contract or unexpired lease on account of an assignment is null and void. *Id.* at § 365(f)(1).

XI. PARTICIPANTS IN THE BANKRUPTCY PROCESS

Bankruptcy Court. The bankruptcy court is a unit of the federal district court for the judicial district in which it is located.

Debtor in Possession. Upon the filing of a chapter 11 case, the debtor becomes a "debtor in possession" unless and until a trustee is appointed to displace the debtor. A debtor in possession is automatically authorized to continue to operate in the ordinary course of business without the necessity of any court authorization. 11 U.S.C. § 1107.

Upon the filing of a chapter 7 case, the United States Trustee appoints a disinterested person from a panel of trustees established under 28 U.S.C. § 586(a)(1) to serve as an interim trustee. Generally, an interim trustee protects a debtor's assets until the first meeting of creditors required pursuant to section 341 of the Bankruptcy Code.

At the "341 meeting" creditors may elect a permanent trustee. In the absence of an election by creditors, the interim trustee is automatically appointed the permanent trustee. 11 U.S.C. § 702(d). Section 704 of the Bankruptcy Code lists the duties of a trustee, which include, among others: (i) collecting and reducing to money the debtor's property as expeditiously as possible with the best interests of parties in interest; (ii) being accountable for all property received; (iii) investigating the financial affairs of the debtor; and (iv) if the business of the debtor is authorized to be operated, file with the court and transmit to the United States Trustee and any relevant taxing authority periodic reports and summaries of business operations, including any information required by the court or the United States Trustee.

In certain instances, such as where the sale of a business as a going concern will increase sale proceeds as opposed to a business that has ceased operating, the chapter 7 trustee may, pursuant to section 721 of the Bankruptcy Code, request court approval to operate the debtor's business for a limited period. *Id.* at § 721.

Creditor. A "creditor" is an entity to whom a payment is owed by the debtor and, therefore, has a claim against the debtor. 11 U.S.C. § 101(10). Creditors' claims fall into different classes depending on whether they are secured by collateral or are accorded priority pursuant to the Bankruptcy Code.

Creditors' Committee. In most chapter 11 cases, the United States Trustee appoints a statutory committee of unsecured creditors, which ordinarily consists of representatives of the largest noninsider, unsecured creditors of the debtor. 11 U.S.C. § 1102. This creditors' committee owes fiduciary duties to all unsecured creditors. *Id.* at § 1103.

Examiner. If the bankruptcy court does not order the appointment of a trustee, the bankruptcy court may, for cause, and in some cases must, order the appointment of an examiner to conduct an investigation of the debtor's conduct and affairs. 11 U.S.C. § 1104(c).

Professionals. Pursuant to section 327(a) of the Bankruptcy Code, a debtor is permitted to employ professionals such as attorneys, accountants, appraisers, auctioneers, or other professional persons with bankruptcy court approval if such professionals (i) do not hold or represent any interest to the estate and (ii) are disinterested. 11 U.S.C. § 327.

A professional is "disinterested" if it (A) is not a creditor, an equity security holder, or an insider; (B) is not and was not, within 2 years before the date of the filing of the petition, a director, officer, or employee of the debtor; and (C) does not have an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor, or for any other reason. *Id.* at § 101(14).

In addition to hiring professionals in connection with a bankruptcy case under section 327(a), a debtor may also retain attorneys who have previously represented the debtor for a special purpose not related to the bankruptcy case. *Id.* at § 327(e). Special purpose attorneys do not need to satisfy the "disinterested" standard under section 327(a). Instead, a court must find that special purpose attorneys do not represent or hold any interest adverse to the debtor or to the estate *with respect to the matter on which the attorneys are to be employed*. *Id.* at § 327(e) (emphasis added).

Secured Creditor. A secured creditor is a creditor who has the right, on the debtor's default, to proceed against collateral and apply it to the payment of the debt.

United States Trustee. The United States Trustee Program is a component of the United States Department of Justice responsible for overseeing the administration of bankruptcy cases and private trustees. A United States Trustee is different from a court-appointed bankruptcy trustee.

Unsecured Creditor. A creditor holding a claim that is based on a debt or obligation that is not secured by a lien or otherwise subject to a security interest.

XII. CHAPTER 7 LIQUIDATION

Chapter 7 of the Bankruptcy Code has two primary goals. First, it provides creditors with an equitable share of a debtor's nonexpempt assets. Second, it grants individual debtors, but not corporate debtors, a fresh start by discharging certain debts. 11 U.S.C. § 727(a)(1).

Chapter 7 contemplates an expeditious, orderly liquidation of all of the debtor's non-exempt property. A debtor's assets and properties are converted to cash by an appointed trustee and distributed to creditors in accordance with the priority scheme established under the Bankruptcy Code. Chapter 7 trustees convert property of the estate to cash through either public or private sales. All sales of property of the estate are governed under section 363 of the Bankruptcy Code and Rule 6004 of the Federal Rules of Bankruptcy Procedure. Section 363 permits a chapter 7 trustee to sell an asset, "after notice and a hearing," and, in certain instances, sell property of the estate free and clear of all liens and claims. Bankruptcy Rule 6004 governs notice procedures in connection with a proposed sale of property.

In addition to selling estate property, a chapter 7 trustee is also required, before a final distribution of property of the estate, to "dispose of any property in which an entity other than the estate has an interest, such as a lien." 11 U.S.C. § 725. This section is intended to "ensure that collateral or its proceeds is returned to the proper secured creditor, that consigned or bailed goods are returned to the consignor or bailor, and so on." H.R. Rep. No. 95-595, 95th Cong., 1st. Sess. 382-83 (1977).

Pursuant to section 726 of the Bankruptcy Code, property of the estate in a chapter 7 case must be distributed to holders of allowed claims according to the following order of priorities:

1. First, to claims in accordance with the priority scheme under section 507 of the Bankruptcy Code, which must be evidenced in a timely filed proof of claim or, if tardily filed, before the earlier of 10 days after the mailing of the summary of the chapter 7 trustee's final report to creditors or the date when the chapter 7 trustee commences distribution.

2. Second, allowed general unsecured claims, excluding priority claims, certain late filed claims, and claims for any fine, penalty, punitive, or similar damages that are not compensation for an actual pecuniary loss (tardily filed claims may be paid if the tardiness was due to lack of notice or knowledge of the case and provided that a proof of claim was filed in time to permit payment of the claim).

3. Third, tardily filed unsecured claims that are allowed and do not qualify for distribution under the second priority.

4. Fourth, allowed, secured, or unsecured claims for any fine, penalty, or punitive damages arising before the earlier of the commencement of the chapter 7 case or the appointment of a trustee, to the extent such claims are not for compensation for actual pecuniary loss.

5. Fifth, allowed claims for interest at the legal rate from the commencement of the chapter 7 case on any claims paid under the aforementioned priorities.

6. Sixth, to the debtor.

11 U.S.C. §§ 726(a)(1)-(6).

XIII. CHAPTER 11 REORGANIZATION

Upon the filing of a chapter 11 petition, the debtor becomes a "debtor in possession" unless and until a trustee is appointed to displace the debtor. 11 U.S.C. § 1107. A debtor is permitted to remain in possession of its property and to operate its business. *Id.* at § 1108. A trustee may be appointed upon a showing of "cause, including fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor by current management" or "if such appointment is in the interest of creditors, any equity security holders, and other interests of the estate, without regard to the number of holders of securities of the debtor or the amount of assets or liabilities of the debtor." *Id.* at § 1104. The appointment of a trustee in a chapter 11 case is rare.

Transactions In and Outside the Ordinary Course of Business. No court order is required for the conduct of business in the ordinary course. 11 U.S.C. § 363(c). Any proposed transaction out of the ordinary course of the debtor's business, such as the sale of significant assets, must be approved by the bankruptcy court. *Id.* at § 363(b).

Administrative Expenses. Generally, a debtor may pay the costs and expenses of administering the bankruptcy estate in the ordinary course of business without a court order. 11 U.S.C. § 363(c). The Bankruptcy Code also permits parties to file a request for payment or reimbursement of these "administrative expenses." *Id.* at § 503(a). Administrative claims are afforded priority treatment and are generally entitled to payment in full. *Id.* at §§ 503(b), 507(a)(2). Administrative expense status is also accorded to the value of any goods received by the debtor in the ordinary course of business within 20 days before the filing of a bankruptcy petition. *Id.* at § 503(b)(9).

Cash Collateral. "Cash Collateral" means cash, negotiable instruments, documents of title, securities, deposit accounts or other cash equivalents whenever acquired in which the estate and an entity other than the estate (such as a secured lender) have an interest, as well as the proceeds, products, offspring, rents, or profits of property subject to a security interest. 11 U.S.C. § 363(a). A debtor may not use, sell, or lease cash collateral, in or out of the ordinary course of business, unless the entity whose claim is secured by the cash collateral consents or the court authorizes such use after notice and a hearing. *Id.* at § 363(c)(2).

Postpetition Financing. If a debtor requires additional financing beyond the use of cash collateral, and operations are adequate or sufficient assets are available to secure new loans, a debtor may seek court authority to obtain postpetition financing pursuant to section 364 of the Bankruptcy Code. Postpetition financing is often provided by the debtor's prepetition lender(s) through a new credit facility. Section 364 of the Bankruptcy Code provides special protections to entities that extend postpetition credit to a debtor, ranging from granting a superpriority administrative expense claim to granting a lien that may prime an existing lien. 11 U.S.C. §§ 364(c), (d).

Adequate Protection. A secured creditor is entitled to adequate protection from a decrease in the value of the secured creditor's interest in collateral resulting from (1) the imposition of the automatic stay; (2) the debtor's use of the property; or (3) the granting of a lien on the property to another lender to secure postpetition financing. 11 U.S.C. §§ 362, 363, 364. Section 361 of the Bankruptcy Code provides three non-exclusive methods of providing adequate protection to creditors: (a) periodic cash payments, (b) additional or replacement liens, and (c) other relief providing the "indubitable equivalent" of the entity's lien on the property. If the value of the collateral exceeds the amount of a secured claim, the existence of the "equity cushion" may itself constitute adequate protection. *See Matter of Mendoza,* 111 F.3d 1264 (5th Cir. 1997); *In re Baytown Nav., Inc.*, 2012 WL 1123047 (Bankr. S.D. Tex. Apr. 3, 2012).

Prepetition Wages, Vacation Pay and Other Benefits. The debtor is precluded from paying any prepetition claims without authorization from the bankruptcy court. Therefore, it is common for a debtor to file a motion with the bankruptcy court at the inception of a chapter 11 case to pay all prepetition amounts owed to current employees. Such payments are justified on the need to maintain employee morale during the chapter 11 case and because all or a portion of such amounts would be entitled to priority in payment upon confirmation of a chapter 11 plan. For example, an employee's claim for wages or commissions earned (including severance, sick or vacation pay) qualifies for such priority up to the amount of $12,475 if such amounts were earned within 180 days before the commencement of the case. 11 U.S.C. § 507(a)(4).

The Chapter 11 Plan

For the first 120 days after the commencement of a chapter 11 case, and if no trustee is appointed, only a debtor may file a chapter 11 plan, which is generally referred to as the exclusive period. 11 U.S.C. § 1121(b). If a chapter 11 plan is filed within the 120-day exclusive period, the debtor may solicit acceptances of the plan until 180 days after the commencement date. *Id.* at § 1121(c)(3). These time periods may be extended for cause by order of the bankruptcy court. *Id.* at § 1121(d). In larger chapter 11 cases, these periods routinely are extended as long as the debtor is proceeding in good faith toward the proposal of a plan. However, the 120-day exclusive period to file a plan cannot be extended beyond 18 months after the commencement date and the 180-day exclusive period to solicit acceptances of a plan cannot be extended beyond 20 months after the commencement date. *Id.* Upon the expiration of a debtor's exclusive period, any party in interest may propose and file a plan. *Id.* at § 1121(c).

Section 1123(a) of the Bankruptcy Code provides that a chapter 11 plan must:

1. designate classes of claims and interests, other than types of priority claims enumerated under section 1123(a)(1);

2. specify any class of claims or interests that is not impaired under the plan;

3. specify the treatment any class of claims or interests that is impaired under the plan;

4. provide the same treatment for each claim or interest within a particular class, unless a holder of a claim or interest agrees to less favorable treatment;

5. provide adequate means for the plan's implementation---such as retention by the debtor of all or part of the property of the estate, satisfaction or modification of any lien, curing or waiving of any default, cancellation or modification of any indenture or similar instrument, or the sale of all or any part of property of the estate;

6. for corporate debtors, provide for the inclusion in the debtor's charter a provision prohibiting the issuance of nonvoting stock and to provide an appropriate distribution of voting power among classes of voting securities;

7. contain only provisions that are consistent with the interests of creditors and equity security holders and with public policy with respect to the manner of selection of any officer, director or trustee and their successors under a plan; and

8. in the case where the chapter 11 debtor is an individual, provide for a payment to creditors from the debtor's postpetition salary or future earnings in an amount that is sufficient to execute the plan.

Id. at § 1123(a).

Section 1123(b) provides that a chapter 11 plan *may* include the following provisions:

1. impair or leave unimpaired any class of claims, secured or unsecured, or interests;

2. provide for the assumption, rejection or assignment of executory contracts or unexpired leases that have not previously been assumed, rejected or assigned in the bankruptcy case;

3. provide for the settlement or adjustment of claims or interests belonging to the debtor or the debtor's estate or the retention and enforcement by the debtor, or by a representative of the estate appointed for such purpose, of any such claim or interest;

4. provide for the sale of all or substantially all of the property of the estate and the distribution of sale proceeds of such sale among holders of claims or interests;

5. modify the rights of holders of certain secured and unsecured claims, or leave those rights unaffected; and

6. include any other provisions consistent with the applicable provisions of the Bankruptcy Code. *Id.* at § 1123(b).

Classification of Claims and Interests. A claim or interest may be placed in a particular class only if it is "substantially similar" to other claims or interests in that class. 11 U.S.C. § 1122(a).

The Absolute Priority Rule. The Bankruptcy Code codifies the absolute priority rule, pursuant to which no class of creditors or equity holders may receive any distribution under a chapter 11 plan unless all creditors and equity holders having claims or interests senior to such class have been paid in full. *See, e.g., Bank of New York Trust Co. v. Official Unsecured Creditors' Comm. (In re Pacific Lumber Co.),* 584 F.3d 229 (5th Cir. 2009). In certain instances, parties in senior classes may, however, agree to make a distribution available to junior classes to obtain confirmation of a consensual plan.

The Disclosure Statement. In order to solicit acceptances of a plan from eligible holders of voters, a "disclosure statement" must be approved by the bankruptcy court. 11 U.S.C. § 1125. The disclosure statement essentially describes the debtor's business, significant events that occurred during the chapter 11 case, the manner in which claims and interests are treated under the chapter 11 plan, and how the plan will be implemented.

Section 1125(b) of the Bankruptcy Code requires a court finding, after notice and a hearing, that the disclosure statement "adequate information." *Id.* at § 1125(b). Adequate information is defined as the "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, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the claims of claims or interests in the case, that will enable a hypothetical investor of the relevant class to make an informed judgment about the plan." *Id.* at § 1125(a)(1). A typical investor, means an investor having (1) a claim or interest in the relevant class; (2) such a relationship with the debtor as the holders of other claims or interests in the class generally have; and (3) such ability to obtain information from sources other than the disclosure required by section 1125 as holders of claims or interests in the class generally have. *Id.* at § 1125(a)(2).

Courts have broad discretion in determining whether a disclosure statement contains adequate information, and such a determination is made on a case-by-case basis, focusing on the unique facts and circumstances of each case. *See Mabey v. Southwestern Elec. Power Co. (In re Cajun Elec. Power Coop.),* 150 F.3d 503 (5th Cir. 1998).

Courts generally consider the following factors when determining the adequacy of information in a proposed disclosure statement:

1. the events which led to the filing of a bankruptcy petition;

2. a description of the available assets and their value;

3. the anticipated future of the company;

4. the source of information stated in the disclosure statement;

5. a disclaimer;

6. the present condition of the debtor while in chapter 11;

7. the scheduled claims;

8. the estimated return to creditors under a chapter 7 liquidation;

9. the accounting method utilized to produce financial information and the name of the accountants responsible for such information;

10. the future management of the debtor;

11. the chapter 11 plan or a summary thereof;

12. the estimated administrative expenses, including attorneys' and accountants' fees;

13. the collectability of accounts receivable;

14. financial information, data, valuations or projections relevant to the creditors' decision to accept or reject the chapter 11 plan;

15. information relevant to the risks posed to creditors under the plan;

16. the actual or projected realizable value from recovery of preferential or otherwise voidable transfers;

17. litigation likely to arise in a nonbankruptcy context; and

18. the relationship of the debtor with affiliates.

See, e.g., *In re U.S. Brass*, 194 B.R. 420 (Bankr. E.D. Tex. 1996) (citing *In re Metrocraft Publ'g Servs., Inc.*, 39 B.R. 567 (Bankr. N.D. Ga. 1984)).

Note: In the Fifth Circuit, a disclosure statement should, at a minimum, specifically reference categories of claims that a reorganized debtor or trustee may pursue and attempt to identify potential third parties who could be subject to such post-confirmation claims. http://business-finance-restructuring.weil.com/wp-content/uploads/2011/08/Texas-Wyoming_2011-WL-2899383_7-21-11.pdf*Spicer v. Laguna Madre Oil & Gas II, LLC et al. (In re Texas Wyoming Drilling, Inc.)*, 647 F.3d 547 (5th Cir. 2011). In addition, courts in the Fifth Circuit may expressly consider language in a disclosure statement in assessing post- confirmation standing of a reorganized debtor to bring claims against third parties *Id.* Therefore, interested parties representing a party that may be sued by a reorganized debtor or trustee should carefully review all plan-related documents.

Acceptance of Chapter 11 Plan. A chapter 11 plan is accepted by a class of claims if it has been accepted by creditors that hold at least two-thirds in dollar amount and more than one-half in number of the allowed claims of such class held by creditors that have voted on the plan. 11 U.S.C. § 1126(c). A plan is accepted by a class of equity interests if it has been accepted by holders of equity interests with at least two-thirds in amount of allowed equity interests in such class that voted on the plan. *Id.* at § 1126(d).

Cramdown. Section 1129(b) of the Bankruptcy Code provides the circumstances under which a chapter 11 plan may be confirmed notwithstanding the failure of a class of claims or interests to accept the plan – the "cram-down" standard. A chapter 11 plan may be confirmed notwithstanding the failure to obtain acceptances from each class if the plan does not discriminate unfairly and is fair and equitable with respect to each dissenting class. 11 U.S.C. § 1129(b).

The unfair discrimination prong ensures that a chapter 11 plan allocates value to a dissenting class "consistent with the value allowed other classes with similar legal claims." *In re MCorp. Fin., Inc.*, 160 B.R. 941 (Bankr. S.D. Tex. 1993).

The Bankruptcy Code sets forth the following standards of fair and equitable for different creditor and equity interest classes.

- *Secured Creditors*: (i) the holder of the claim retains its liens securing such claim and receives deferred cash payments totaling at least the allowed amount of its claim, which cash payments have a present value equal to the value of the creditor's collateral; (ii) the holder realizes the "indubitable equivalent" of its claim, or (iii) the property that is subject to the liens is sold and the liens attach to the proceeds of such sale and the plan provides treatment of the lien on proceeds in accordance with clause (i) or (ii) above. 11 U.S.C. § 1129(b)(2)(A).

- *Unsecured Creditors*: (i) the plan provides that each holder of a claim in the class receives or retains property of a value, as of the effective date of the plan, equal to the allowed amount of such claim, or (ii) the holder of any claim or interest that is junior to the claims of such class will not receive or retain any property on account of such junior claim or interest. *Id.* at § 1129(b)(2)(B).

- *Equity Interest Holders*: (i) the plan provides that each holder of an interest receives or retains property of a value, as of the effective date of the plan, equal to the greatest of the allowed amount of any fixed liquidation preference to which such holder is entitled, any fixed redemption price, or the value of such interest, or (ii) the holder of any interest that is junior to the interests of such class will not receive or retain under the plan any property. *Id.* at § 1129(b)(2)(C).

Effect of Confirmation. Confirmation of a chapter 11 plan binds the debtor, all creditors and all equity security holders, in many instances whether or not they voted to accept the plan, vests all property of the estate in the debtor and discharges the debtor from any debt that arose before the date of confirmation. 11 U.S.C. § 1141. As previously noted, however, the confirmation of a chapter 11 plan does not discharge a debtor if the plan provides for the liquidation of all or substantially all of the property of the estate, the debtor does not engage in business after consummation of the plan, and the debtor would be denied a discharge under section 727(a) of the Bankruptcy Code if the chapter 11 case were a chapter 7 liquidation case. *Id.* at § 1141(d).