# Bankruptcy & Insolvency Taxation

Third Edition

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# CHAPTER ONE

# Nature of Bankruptcy & Insolvency Proceedings



## § 1.1 OBJECTIVES

### (a) Introduction

The income tax effect of certain transactions during the administration period and of tax assessments related to pre-bankruptcy periods can impose undue hardship on the bankrupt, who is already in a tenuous financial position. It is not uncommon for a bankrupt to realize substantial taxable income during the administration period from the sale of all or part of the assets or from taxable recoveries. Net operating loss carryovers and other offsetting tax deductions are often unable to minimize the income tax effect. Therefore, in addition to ensuring that all statutory tax reporting and filing requirements are satisfied at the due dates, the accountant must be aware of those tax aspects that will permit the preservation and enlargement of the bankrupt's estate.

During the closing days of the 96th Congress, the Bankruptcy Tax Act of 1980 was passed as Public Law 96-589 and signed by President Carter on December 24, 1980. This bill eliminated a great deal of the uncertainty about handling debt forgiveness and other tax matters, as the Bankruptcy Code superseded the sections of the Bankruptcy Act that contained provisions for nonrecognition of gain from debt forgiveness along with other related tax items. The Bankruptcy Code contains state and local tax law but no federal tax provisions. The new Bankruptcy Tax Act was passed after some last-minute compromises. Included was an amendment that delayed until January 1, 1982, the requirement that net operating losses be reduced by the amount of debt that is forgiven. This was designed to allow one year for Congress to consider comments from the public regarding the handling of debt forgiveness. Sections of the Bankruptcy Tax Act and other sections of the Bankruptcy Code relating to the tax issues of troubled businesses were changed by the several tax reform acts since it was passed.

The purpose of this book is to analyze in detail the tax ramifications of bankruptcy and insolvency proceedings and to provide a practical guide that will assist financial advisors, accountants, attorneys, and other related professionals in rendering tax services in the liquidation and rehabilitation of financially troubled debtors in and out of bankruptcy court. The book should be of interest to debtors, business turnaround professionals, trustees, appraisers, and other professionals who assist debtors or creditors of debtors that are experiencing financial difficulty. While these professionals may not be directly involved in rendering professional tax services, they must be aware of the tax consequences of many decisions they make or recommend in bankruptcy cases or out-of-court settlements.

### (b) Scope of Coverage

This book describes the tax aspects of a separate estate created for individuals in a chapter 7 or 11 case. The tax ramifications of discharge of debt in and out of bankruptcy court are discussed for both the debtor and creditors. A full chapter is devoted to a discussion of the use of net operating losses by corporations. Tax priorities, assessments, discharges, and authority in bankruptcy are described in the last three chapters.

The Bankruptcy Tax Act significantly changed the ways in which a corporation can be reorganized in a bankruptcy proceeding. The new type "*G*" reorganization created under the Act is analyzed, along with the other aspects of tax reorganization. Other special tax problems are described, such as impact of debt forgiveness on the earnings and profit account and tax issues related to partnerships and S corporations.

The balance of this chapter describes briefly the nature of out-of-court settlements and reorganization or liquidation in a title 11 bankruptcy case. This discussion is intended only to provide the reader with a basic introduction to out-of-court and bankruptcy proceedings. For a more detailed discussion of the legal aspects of and the accounting for out-of-court settlements and bankruptcy cases, see Newton's *Bankruptcy and Insolvency Accounting: Practice and Procedure* (Wiley; updated annually).

## § 1.2 ALTERNATIVES AVAILABLE TO A FINANCIALLY TROUBLED BUSINESS

A debtor's first alternatives are to locate new financing, to merge with another company, or to find some other basic solution to its situation in order to avoid the necessity of discussing its problem with representatives of creditors. If none of these alternatives is possible, the debtor may be required to seek a remedy from creditors, either informally (out of court) or with the help of judicial proceedings.

### (a) Out-of-Court Settlements

An out-of-court settlement is an informal agreement that usually consists of an extension of time (stretch-out), a pro rata cash payment for full settlement of claims (composition), an issue of stock for debt, or some combination of these methods. The debtor, through a counselor credit association, calls an informal meeting of the creditors for the purpose of discussing its financial problems. In many cases, the credit association makes a significant contribution to the out-of-court settlement by arranging a meeting of creditors, providing advice, and serving as secretary for the creditors' committee.

A credit association is composed of credit managers of various businesses in a given region. Its functions are to provide credit and other business information to member companies concerning their debtors, to help make commercial credit collections, to support legislation favorable to business creditors, and to provide courses in credit management for members of the credit community. At the creditors' meeting, the debtor will describe the causes of failure, discuss the value of assets (especially those unpledged) and unsecured liabilities, and answer any questions the creditors may ask. The main objective of this meeting is to convince the creditors that they would receive more if the business were allowed to operate than if it were forced to liquidate and that all parties would be better off if a settlement could be worked out.

#### *(i) Creditors' Committee*

To make it easier for the debtor to work with the creditors, a committee of creditors may be appointed during the initial meeting of the debtor and its creditors, providing, of course, the case is judged to warrant some cooperation by the creditors. The creditors are often as interested in working out a settlement as is the debtor.

There is no set procedure for the formation of a committee. Ideally, the committee should consist of four or five of the largest creditors and one or two representatives from the smaller creditors. A lot of time wasted on deciding the size and composition of the committee would be saved at creditors' meetings if the committees were organized routinely in this manner. However, there are no legal or rigid rules defining the manner in which a committee may be formed. Although a smaller creditor may often serve on a committee, there are committees on which only the larger creditors serve, either because of lack of interest on the part of the smaller creditors or because the larger creditors override the wishes of others.

The debtor's job of running the business while under the limited direction of the creditors' committee can be made easier if the creditors selected are those most friendly to the debtor.

#### *(A) Duties of Committee*

The creditors' committee serves as the bargaining agent for the creditors, supervises the operation of the debtor during the development of a plan, and solicits acceptance of a plan once it has been approved by the committee. Generally, the creditors' committee will meet as soon as it has been appointed, for the purpose of electing a presiding officer and counsel. The committee will also engage a financial advisor to help the members understand the nature of the debtor's problems and evaluate the debtor's business plan.

At the completion of the audit, the creditors' committee will meet to discuss the results. If the audit reveals that the creditors are dealing with a dishonest debtor, the amount of settlement that will be acceptable to the creditors will be increased significantly. It becomes very difficult for a debtor to avoid a bankruptcy court proceeding under these conditions. However, if the debtor is honest and demonstrates the ability to reverse the unprofitable operations trend and reestablish the business, some type of plan may eventually be approved.

### *(ii) Plan of Settlement*

It is often advisable, provided there is enough time, for the financial advisor and the attorney to assist the debtor in preparing a suggested plan of settlement so it can be presented and discussed at the first meeting with creditors. Typically, only the largest creditors and a few representatives of the smaller creditors are invited in order to avoid having a group so large that little can be accomplished.

There is no set form that a plan of settlement proposed by the debtor must take. It may call for 100 percent payment over an extended period of time, payments on a pro rata basis in cash for full settlement of creditors' claims, satisfaction of debt obligations with stock, or some combination. A carefully developed forecast of projected operations, based on realistic assumptions developed by the debtor with the aid of its accountant, can help creditors determine whether the debtor can perform under the terms of the plan and operate successfully in the future.

Generally, for creditors to accept a plan, the amount they will receive must be at least equal to the dividend they would receive if the estate were liquidated. This dividend, expressed as a percentage, is equal to the sum of a forced-sale value of assets, accounts receivable, cash, and prepaid items minus priority claims, secured claims, and expenses of administration divided by the total amount of unsecured claims.

The plan should provide that all costs of administration, secured claims, and priority claims, including wages and taxes, are adequately disposed of for the eventual protection of the unsecured creditors. If the debtor's plan includes a cash down payment in full or partial settlement, the payment should at least equal the probable dividend the creditors would receive in bankruptcy.

### *(iii) Acceptance of Plan*

After the creditors' committee approves a plan, it will notify all the other creditors and recommend to them that they accept the plan. Even if a few creditors do not agree, the debtor should continue with the plan. The dissenting creditors will eventually have to be paid in full. Some plans even provide for full payment to small creditors, thus destroying the nuisance value of the small claims. In an informal agreement, there is no provision binding the minority of creditors to accept the will of the majority. Thus, it is necessary to obtain the approval of almost all of the creditors in order for an out-of-court settlement to be successful.

### *(iv) Advantages and Disadvantages*

Summarized below are a few of the reasons why the informal settlement is used in today's environment:

- The out-of-court settlement is less disruptive to a business that continues operating.
- The debtor can receive considerable benefits from the advice of a committee, especially if some of the committee members have extensive business experience, preferably but not necessarily in the same line of business.
- The informal settlement avoids invoking the provisions of the Bankruptcy Code and, as a result, more businesslike solutions can be adopted.
- Frustrations and delays are minimized because problems can be resolved properly and informally without the need for court hearings.
- An agreement can usually be reached much faster informally than in court proceedings.
- The costs of administration are usually less in an out-of-court settlement than in a formal reorganization.

The weaknesses of informal composition settlements are:

- A successful plan of settlement requires the approval of substantially all creditors, and it may be difficult to persuade distant creditors to accept a settlement that calls for payment of less than 100 percent.
- The assets of the debtor are subject to attack while a settlement is pending. (The debtor can, of course, point out to the creditors that if legal action is taken, a petition in bankruptcy court will have to be filed.)
- The informal composition settlement does not provide a method to resolve individual disputes between the debtor and the creditors.
- Executory contracts, especially leases, may be difficult to avoid.

- Certain tax law provisions make it more advantageous to file a bankruptcy court petition.
- Priority debts owed to the United States under Rev. Stat. section 3466 must be paid first.

### (b) Assignment for Benefit of Creditors

A remedy available under state law to a corporation in serious financial difficulties is an *assignment for the benefit of creditors.* In this instance, the debtor voluntarily transfers title to its assets to an assignee, which then liquidates them and distributes the proceeds among the creditors. Assignment for the benefit of creditors is an extreme remedy because it results in the cessation of the business. This informal liquidation device (although court-supervised in many states) is like the out-of-court settlement devised to rehabilitate the debtor, in that it requires the consent of all creditors or at least their agreement to refrain from taking action. The appointment of a custodian over the assets of the debtor gives creditors the right to file an involuntary bankruptcy court petition.

Proceedings brought in the federal courts are governed by the Bankruptcy Code. Normally, it will be necessary to resort to such formality when suits have been filed against the debtor and its property is under garnishment or attachment or is threatened by foreclosure or eviction.

### (c) Bankruptcy Court Proceedings

Bankruptcy court proceedings are generally the last resort for a debtor whose financial condition has deteriorated to the point where it is impossible to acquire additional funds. When the debtor finally agrees that bankruptcy court proceedings are necessary, the liquidation value of the assets often represents only a small fraction of the debtor's total liabilities. If the business is liquidated, the creditors get only a small percentage of their claims. The debtor is discharged of its debts and is free to start over; however, the business is lost and so are all the assets. Normally, liquidation proceedings result in large losses to the debtor, to the creditor, and to the business community in general. Chapter 7 of the Bankruptcy Code covers the proceedings related to liquidation. Another alternative under the Bankruptcy Code is to seek some type of relief so that the debtor will have enough time to work out agreements with creditors with the help of the bankruptcy court and be able to continue operations. Chapters 11, 12, and 13 of the Bankruptcy Code provide for this type of operation

Title 111[1] of the U.S. Code contains the bankruptcy law. The code is divided into eight chapters:

Chapter 1: General Provisions

Chapter 3: Case Administration

Chapter 5: Creditors, the Debtor, and the Estate

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[1] The Bankruptcy Code as originally passed consisted of only odd-numbered chapters. In 1986, Congress added chapter 12.

Chapter 7: Liquidation

Chapter 9: Adjustment of Debts of a Municipality

Chapter 11: Reorganization

Chapter 12: Adjustment of Debts of a Family Farmer with Regular Income

Chapter 13: Adjustment of Debts of an Individual with Regular Income

Chapters 1, 3, and 5 apply to all proceedings under the code, except in chapter 9, where only those sections of chapters 1, 3, and 5 specified apply. A case commenced under the Bankruptcy Code's chapters 7, 9, 11, 12, or 13 is referred to as a *title 11 case.*

### (d) Provisions Common to All Bankruptcy Proceedings

A voluntary case is commenced by the filing of a bankruptcy petition under the appropriate chapter by the debtor. An involuntary petition can be filed by creditors with aggregate unsecured claims of at least $12,300[2] and can be initiated only under chapter 7 or 11. If there are 12 or more creditors with unsecured claims, at least three creditors must sign the petition; if the number of unsecured creditors is less than 12, a single creditor can force the debtor into bankruptcy. Only one of two requirements must be satisfied in order for the creditors to force the debtor into bankruptcy:

1. The debtor generally fails to pay its debts as they become due, or
2. Within 120 days prior to the petition, a custodian was appointed or a custodian took possession of substantially all of the debtor's property.

#### *(i) Automatic Stay*

A petition filed under the Bankruptcy Code results in an automatic stay of the actions of creditors. As a result of the stay, no party, with minor exceptions, having a security or adverse interest in the debtor's property can take any action that will interfere with the debtor or its property, regardless of where the property is located, until the stay is modified or removed. The debtor or the trustee is permitted to use, sell, or lease property (other than cash collateral) in an ordinary course of business without a notice or hearing, provided the business has been authorized to operate in a chapter 7, 11, 12, or 13 proceeding and the court has not restricted the powers of the debtor or trustee in the order authorizing operation of the business.

In bankruptcy proceedings, the debtor or trustee also has the power to assume or reject any executory contract or any unexpired lease of the debtor.

[2] Many of the dollar amounts in the Bankruptcy Code are increased to reflect the change in the Consumer Price Index for all Urban Consumers for the most recent three-year period ending immediately before January 1 of the year that the three-year interval begins on April 1. The amounts are to be rounded to the nearest $25 dollar amount. Effective April 1, 2004, the minimum amount needed to file an involuntary petition was established at $12,300. The $12,300 value remains effective until April 1, 2007.

### *(ii) Priorities*

The 1978 Bankruptcy Code modified to a limited extent the order of payment of the expenses of administration and other unsecured claims. Section 507 of the Bankruptcy Code provides for the following priorities:

1. Administrative expenses.
2. In an involuntary case, unsecured claims arising after commencement of the proceedings but before an order of relief is granted.
3. Wages earned within 90 days prior to filing the petition (or to the cessation of the business) to the extent of $4,925 per individual.
4. Unsecured claims to employee benefit plans arising within 180 days prior to filing the petition, but limited to $4,925 times the number of employees less the amount paid in priority 3 above.
5. Unsecured claims of grain producers against grain storage facilities and claims of fishermen against product storage or processing facilities to the extent of $4,925 for each such individual.
6. Unsecured claims of individuals to the extent of $2,225 from deposits of money for purchase, lease, or rental of property or purchase of services not delivered or provided.
7. Claims for alimony, maintenance, and support due but not paid.
8. Unsecured tax claims of governmental units (discussed in more detail in chapter 11).
9. Allowed unsecured claims based on any commitment by the debtor to regulation agencies of the federal government to maintain the capital of an insured depository institution.

### *(iii) Discharge of Debts*

The Bankruptcy Code contains provisions that allow an individual debtor in a chapter 7, 11, or 12 proceeding to have its debts discharged. A corporation may also have its debts discharged in chapter 11 or 12; however, these debts cannot be discharged in a chapter 7 or 11 liquidation. Chapter 13 has some special provisions that deal with the discharged of debt and allow additional taxes to be discharged that could not be discharged in a chapter 7 or 11 proceeding. Included among debts that may not be discharged are certain types of taxes. These taxes will be discussed in Chapter 11 of this text.

### *(iv) Preferences*

The Bankruptcy Reform Act of 1978 substantially modified the handling of preferential payments. Section 547 of the Bankruptcy Code provides that a trustee or debtor-in-possession can avoid transfers that are considered preferences. The trustee may avoid any transfer of property of the debtor:

- To or for the benefit of a creditor.
- For or on account of an antecedent debt owed by the debtor before such transfer was made.

- Made while the debtor was insolvent.
- Made:
  - On or within 90 days before the date of the filing of the petition, or
  - Between 90 days and one year before the date of the filing of the petition if such creditor, at the time of such transfer, was an insider
- That enables such creditor to receive more than it would receive if
  - The case were a case under chapter 7 of this title,
  - The transfer had not been made, or
  - Such creditor received payment of such debt to the extent provided by the provisions of this title.

**Note that** for an *insider*, the debtor can go back an entire year to void the transfer. However, the one year only applies to an insider and not to a third party. For example, if the president of the debtor company paid a bank loan 100 days prior to the filing of the petition, action to recover the preference could be taken against the president, but not against the bank.

Certain exemptions apply to preferential payments. One of these is a contemporaneous exchange: an exchange (payment) for new value, such as inventory not previously received, is given to the debtor. For example, the purchase of goods or services with payment by check or cash would not be a preferential payment. The second exemption protects payments of debts that are incurred in the ordinary course of business or financial affairs of both the debtor and the transferee, when the payment is made in the ordinary course of business according to ordinary business terms. For example, a 30-day open account for utility service would be sheltered provided payment is made according to the normal terms (such as 30 days) and according to ordinary business terms. Security interests granted in exchange for enabling loans, when the proceeds are used to finance the purchase of specific personal property, are also exempt. This exception would allow creditors to isolate from preference attack, a transfer received, to the extent that the creditors replenish the estate with new value. For example, if a creditor received $10,000 in preferential payments and subsequently sold goods with a value of $6,000 to the debtor on unsecured credit, the preference would be only $4,000.

### (e) Chapter 7: Liquidation

Chapter 7 is used only when the corporation sees no hope of being able to operate successfully or to obtain the necessary creditor agreement. Under this alternative, the corporation is liquidated and the remaining assets are distributed to creditors after administrative expenses are paid. An individual debtor may be discharged from liabilities and entitled to a fresh start.

The decision as to whether rehabilitation or liquidation is best also depends on the amount to be realized from each alternative. The method resulting in the greatest return to the creditors and stockholders should be chosen. The amount to be received from liquidation depends on the resale value of the firm's assets minus the costs of dismantling and legal expenses. The value of the firm after rehabilitation must be determined (net of the costs of achieving the remedy). The alternative leading to the highest value should be followed.

Financially troubled debtors often attempt an informal settlement or liquidation out of court, but if it is unsuccessful they will then initiate proceedings under the Bankruptcy Code. Other debtors, especially those with a large number of creditors, may file a petition for relief in the bankruptcy court as soon as they recognize that continuation of the business under existing conditions is impossible. As will be discussed later, the debtor may also liquidate by filing a plan of liquidation under chapter 11.

### *(i) Appointment of Trustee*

As soon as the order for relief has been entered, the U.S. trustee will appoint a disinterested party from a panel of private trustees to serve as the interim trustee. The functions and powers of the interim trustee are the same as those of an elected trustee. Once an interim trustee has been appointed, at a meeting of creditors the creditors will elect a trustee that will be responsible for liquidating the business. If a trustee is not elected by the creditors, the interim trustee may continue to serve in the capacity of the trustee and carry through with an orderly liquidation of the business.

The duties of the trustee are defined in section 704 of the Bankruptcy Code. They include:

- Collect and reduce to money the property of the estate for which such trustee serves and close up such estate as expeditiously as is compatible with the best interests of parties in interest.
- Be accountable for all property received.
- Investigate the financial affairs of the debtor.
- If a purpose would be served, examine proofs of claims and object to the allowance of any claim that is improper.
- If advisable, oppose the discharge of the debtor.
- Unless the court orders otherwise, furnish such information concerning the estate and the estate's administration as is requested by a party in interest.
- If the business of the debtor is authorized to be operated, file with the court and with any governmental unit charged with responsibility for collection or determination of any tax arising out of such operation, periodic reports and summaries of the operation of such business, including a statement of receipts and disbursements, and such other information as the court requires.
- Make a final report and file a final account of the administration of the estate with the court.

The objective of the trustee will be to liquidate the assets of the estate in an orderly manner. Once the property of the estate has been reduced to money and the security claims to the extent allowed have been satisfied, then the property of the estate shall be distributed to the holders of the claims in an order as specified by the Bankruptcy Code. The first order, of course, would be priority claims, and once these claims have been satisfied, the balance will go to unsecured creditors. After all the funds have been distributed, the remaining debts of an individual will be discharged. As mentioned earlier, if the debtor is a corporation, the debts will not be discharged. Thus, it will be necessary for the corporation to cease existence. Any funds subsequently coming into the corporate shell would be subject to attachment.

### (f) Chapter 11: Reorganization

The purpose of chapter 11 is to provide the debtor with court protection, allow the debtor (or trustee) to continue the operations of the business while a plan is being developed, and minimize the substantial economic losses associated with liquidations. Chapter 11 as provided for in the Bankruptcy Code was designed to provide the flexibility of Chapter XI under prior law, yet it contains several of the protective provisions of the old Chapter X. It is designed to allow the debtor to use different procedures depending on the nature of the debtor's problem and the needs of the creditors. Agreements under this chapter can affect unsecured creditors, secured creditors, and stockholders. A voluntary or involuntary petition can be filed under chapter 11. Upon the filing of the involuntary petition, the court may, on request of an interested party, authorize the appointment of a trustee. The appointment is not mandatory and the debtor may, in fact, continue to operate the business as if a bankruptcy petition had not been filed, except that certain transactions may be avoided under the Bankruptcy Code. If the creditors prove the allegations set forth in the involuntary petition, an order for relief is entered, and the case will proceed in a manner identical to that of a voluntary case.

#### *(i) Creditors' Committee*

The Bankruptcy Code provides that a creditors' committee will be appointed consisting of the seven largest unsecured creditors willing to serve or, if a committee was organized before the order for relief, such a committee may continue provided it was chosen fairly and is representative of the different kinds of claims. The purpose of the creditors' committee is very similar to that of a creditors' committee appointed in an out-of-court settlement. The U.S. trustee appoints the committee. The creditors' committee normally acts as the bargaining agent for the larger creditor body and continues to see that the assets of the debtor are protected.

#### *(ii) Operation of Business*

The debtor will continue to operate the business unless a party in interest requests that the court authorize the appointment of a trustee. The U.S. trustee will make the appointment, if authorized by the court. Once the appointment has been authorized, the creditors also have the right to elect a trustee, rather than have one appointed by the U.S. Trustee. It is not necessary for an order to be granted to allow the debtor to continue to operate the business.

### *(iii) Disclosure Statement*

A party cannot solicit the acceptance or rejection of a plan from creditors and stockholders affected by the plan unless they are given a written disclosure statement containing adequate information, as approved by the court. Section 1125(b) of the Bankruptcy Code requires that this disclosure statement must be provided prior to or at the time of the solicitation. The disclosure statement must be approved by the court, after notice and a hearing, as containing adequate information.

Section 1125(a) states that adequate information means information of a kind, and in sufficient detail, as far as is reasonably practicable in light of the nature and history of the debtor and the condition of the debtor's books and records, that would enable a hypothetical reasonable investor, typical of holders of claims or interests of the relevant class, to make an informed judgment about the plan. This definition contains two parts. First it defines adequate information, and then it sets a standard against which the information is measured. It must be the kind of information that a typical investor of the relevant class, not one that has special information, would need to make an informed judgment about the plan.

### *(iv) Developing the Plan*

In cases where the debtor is allowed to operate the business as debtor-in-possession, the debtor has 120 days after the order for relief to file a plan and 180 days after the order for relief to obtain acceptance before others can file a plan. These time periods may be extended or reduced by the court. The Bankruptcy Code allows the debtor to file a liquidation rather than a reorganization plan where liquidation for various reasons may be more appropriate for the debtor. For example, during 2001 and 2002 over one-third of all public company plans confirmed were liquidation plans. Many of them were plans where the assets were sold in a section 363 sale under the provisions of the bankruptcy court and the proceeds distributed to the creditors in a liquidation plan.

Section 1123 of the Bankruptcy Code lists the items that are required to be included in the plan. They are:

1. Designate classes of claims and interests.
2. Specify any class of claims or interests that is not impaired under the plan.
3. Specify the treatment of any class of claims or interests that is impaired under the plan.
4. Provide the same treatment for each claim or interest in a particular class unless the holders agree to less favorable treatment.
5. Provide adequate means for the plan's execution, such as:
   - **(a)** Retention by the debtor of all or any part of the property of the estate,
   - **(b)** Transfer of all or any part of the property of the estate to one or more entities,
   - **(c)** Merger or consolidation of the debtor with one or more persons (individuals, partnerships, and corporations),

- **(d)** Sale of all or any part of the property of the estate, either subject to or free of any lien, or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate,
- **(e)** Satisfaction or modification of any lien,
- **(f)** Cancellation or modification of any indenture or similar instrument,
- **(g)** Curing or waiving of any default,
- **(h)** Extension of a maturity date or a change in an interest rate or other term of outstanding securities,
- **(i)** Amendment of the debtor's charter,
- **(j)** Insurance of securities of the debtor, or of any entity involved in a merger or transfer of the debtor's business for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose.

6. Provide for the inclusion in the charter of the debtor, if the debtor is a corporation, or of any corporation referred to in 5(a) or (b) above, of a provision prohibiting the issuance of nonvoting equity securities, and provide, as to the several classes of securities possessing voting power, an appropriate distribution of such power among such classes, including, in the case of any class of equity securities having a preference over another class of equity securities with respect to dividends, adequate provisions for the election of directors representing such preferred class in the event of default in the payment of such dividends.

In addition to the mandatory requirements listed above, the plan may provide for certain permissible provisions. They include:

- Impair or leave unimpaired any class of unsecured or secured claims or interests.
- Provide for the assumption or rejection of executory contracts or leases.
- Provide for settlement or adjustment of any claim or interest of the debtor or provide for the retention and enforcement by the debtor of any claim or interest.
- Provide for the sale of all of the property of the debtor and the distribution of the proceeds to the creditors and stockholders.
- Include any other provision not inconsistent with the provisions of the Bankruptcy Code.

### *(v) Confirmation of the Plan*

Section 1129(a) of the Bankruptcy Code contains the requirements that must be satisfied before a plan can be confirmed. The provisions are summarized below:

1. **The plan complies with the applicable provisions of title 11.** Bankruptcy Code section 1122, concerning classification of claims, and section 1123, on the content of the plan, are two of the significant sections that must be followed.

2. **The proponents of the plan comply with the applicable provisions of title 11.** Section 1125 of the Bankruptcy Code, on disclosure, is an example of a section that is referred to by this requirement.
3. **The plan has been proposed in good faith and not by any means forbidden by law.**
4. **Payments are disclosed.** Any payment made or promised for services, costs, and expenses in connection with the case or plan has been disclosed to the court; payments made before confirmation are reasonable; and those to be made after confirmation must be subject to the court's approval.
5. **Officers are disclosed.** The proponent of the plan must disclose those who are proposed to serve after confirmation as director, officer, or voting trustee of the reorganized debtor. Such employment must be consistent with the interests of creditors and equity security holders and with public policy. Names of insiders to be employed and the nature of their compensation must also be disclosed.
6. **Regulation rate approval has been obtained.** Any regulatory commission that will have jurisdiction over the debtor after confirmation of the plan must approve any rate changes provided for in the plan.
7. **The-best-interest-of-creditors test has been satisfied.** It is necessary for the creditors or stockholders who do not vote or if voted, did not vote in favor of the plan to receive as much as they would if the business were liquidated under chapter 7.
8. **Each class has accepted the plan.** Each class of creditors that is impaired under the plan must accept the plan. Section 1129(b) provides an exception to this requirement.
9. **Claims are treated in their order of priority.** This requirement provides the manner in which priority claims must be satisfied unless the holders agree to a different treatment.
10. **Acceptance by at least one class has been obtained.** At least one class that is impaired, other than a class of claims held by insiders, must accept the plan.
11. **The plan is feasible.** Confirmation of the plan is not likely to be followed by liquidation or the need for further financial reorganization unless such liquidation or reorganization is provided for in the plan. This requirement means that the court must ascertain that the debtor has a reasonable chance of surviving once the plan is confirmed and the debtor is out from under the protection of the court. A well-prepared forecast of future operations based on reasonable assumptions, taking into consideration the changes expected as a result of the confirmation of the plan, is an example of the kind of information that can be very helpful to the court in reaching a decision on this requirement.
12. **Payment of fees has been arranged.** All quarterly and filing fees must have been paid or the plan must provide that payment will be made on the effective date.
13. **Retiree benefits will continue.** The plan must provide for the continuation of payments of retiree benefits as required under section 1114 of the Bankruptcy Code.

As noted in requirement 8, for a plan to be confirmed, a class of claims or interests must either accept the plan or not be impaired. However, subsection (b) of Bankruptcy Code section 1129 allows the court, under certain conditions, to confirm a plan even though an impaired class has not accepted the plan. The plan must not discriminate unfairly and must be fair and equitable with respect to each class of claims or interest impaired under the plan that has not accepted it. The Bankruptcy Code states conditions for secured claims, unsecured claims, and stockholder interests that would be included in the *fair and equitable* requirement.

#### *(vi) Discharge of Debts*

Once the plan has been confirmed, the Bankruptcy Code provides for discharge of the debts. This would include both individual and corporate debts. However, section 523 of the Bankruptcy Code provides that some debts of individuals may not be discharged. Among the debts that will not be discharged under section 523 are tax claims that have a priority under section 507 of the Bankruptcy Code and taxes for years in which a return was not filed, was filed late and within two years before the petition was filed, or was filed fraudulently.

#### *(vii) Advantages of Chapter 11*

Chapter 11 proceedings may be more appropriate under certain conditions than informal settlements made out of court. Some of Chapter 11's advantages are:

- Rather than near-unanimous approval, majority approval in number or two-thirds in amount of allowed claims of creditors' voting is sufficient to accept a plan of reorganization and bind dissenters.
- Creditors bargain collectively with the debtor, which may result in more equitable treatment of the members of each class of claims or interests.
- The debtor's assets are in the custody of the court and safe from attack when the petition is filed.
- Executory contracts and leases can be cancelled when such action benefits the debtor.
- Financing during the reorganization may be easier to obtain.
- The creditors have an opportunity to investigate the debtor and its business affairs.
- Certain preferential and fraudulent transfers can be avoided by the debtor-in-possession or trustee.
- Proper protection can be provided to holders of public securities.
- Certain tax advantages are available under the Bankruptcy Code.
- Creditors are additionally protected by the requirement that, to be confirmed by the court, the plan must be in the best interests of creditors; be feasible; be fair and equitable to any impaired, dissenting classes; and provide for priority claims.

#### *(viii) Prepackaged or Prenegotiated Chapter 11 Plans*

Before filing a chapter 11 plan, some debtors develop and obtain approval of the plan by all impaired claims and interests. The court may accept the voting that