BANKRUPTCY NEEDS TO GET ITS PRIORITIES STRAIGHT: A PROPOSAL FOR LIMITING THE LEVERAGE OF UNSECURED CREDITORS' COMMITTEES WHEN UNSECURED CREDITORS ARE "OUT-OF-THE-MONEY"

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INTRODUCTION

Imagine the typical modern chapter 11 case. The debtor operates at a loss. The debtor's secured loans are secured by substantially all of the debtor's assets, and the total amount of the secured loans (likely broken into at least two tranches of priority) exceeds the enterprise value of the debtor when it files its chapter 11 case. The debtor, the first lien lenders, and the second lien lenders agree to support the prompt confirmation of a chapter 11 plan pursuant to which the first lien lenders' debt will be reinstated and the second lien lenders' debt will be converted to 100 percent of the equity of the reorganized debtor. At the outset of the chapter 11 case, an official committee of unsecured creditors is appointed. Counsel to the fledgling committee pleads with the bankruptcy judge for a longer runway to study the bankrupt debtor's dealings with its secured lenders and the actions taken by members of its management team. The bankruptcy judge, to the chagrin of the secured lenders, obliges the committee and gives it the breathing room it seeks. The secured lenders, perhaps at the "urging" of the bankruptcy judge, agree to "carve out" some money from the secured lenders' collateral to finance the committee's

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investigation of potential causes of action that may generate distributable value. The committee, of course, consists of "out-of-the-money" creditors seeking any way in which to extract value—and, in the absence of any valid causes of action, the only remaining path may be to cause delay.

After very expensive and time-consuming discovery, the committee has caused the debtor's bankruptcy estate to incur millions of dollars in professional fees and expenses—far more than the amount of the carve-out agreed by the lenders. Yet, regardless of whether any valid or legitimate causes of action exist, to confirm a plan of reorganization, the secured lenders must pay all of these professional fees in full. In larger cases, the secured lenders are then faced with a choice: (a) pay the committee's professional fees amounting to millions of dollars, negotiate a cash distribution for unsecured creditors (effectively a holdup payment) even though they are entitled to nothing, and confirm a plan; (b) seek to confirm the original plan over the objection of the committee, in which case the secured lenders will have to pay the millions of dollars of committee professional fees already incurred, plus the additional fees for preparing and arguing an objection to the plan; or (c) abandon the chapter 11 plan and let the debtor liquidate, maximizing the secured lenders' losses.[1] In smaller cases, the committee's professional fees may be so large as to make confirming any plan economically impossible, in which case liquidation is the only alternative.[2] Should out-of-the-money creditors have that much leverage?

Over the past two decades, the capital structure of the typical corporate entity has changed remarkably. The common corporate capital structure once was a single tranche of secured debt together with a host of unsecured creditors.[3] Today, a typical company has multiple layers of secured debt.[4] One outcome of this shift has been that when a company is financially distressed—and particularly once it is insolvent—the returns to unsecured creditors of such a company may be small to non-existent.[5] Moreover, claims trading has altered the very nature of creditors holding secured and unsecured tranches of corporate debt, which has caused such creditors to take less of an interest in the continued existence of the corporate

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[1] *See infra* Section II.C.

[2] *See, e.g.*, Peter C. Blain & Diane Harrison O'Gawa, *Creditors' Committees Under Chapter 11 of the United States Bankruptcy Code: Creation, Composition, Powers, and Duties*, 73 MARQ. L. REV. 581, 605 (1990) (explaining that because the committee can advise the creditors, it wields significant power over whether the reorganization plan will be adopted).

[3] *See* MARSHALL S. HUEBNER & BENJAMIN A. TISDELL, DAVIS POLK & WARDWELL, THE AMERICAS RESTRUCTURING AND INSOLVENCY GUIDE, AS THE WHEEL TURNS: NEW DYNAMICS IN THE COMING RESTRUCTURING CYCLE, 78 (2008) ("Twenty-five years ago . . . [t]he major creditor participants in corporate reorganisations were usually large commercial banks and other institutional creditors (e.g., insurance companies), indenture trustees representing bondholders and the debtors' vendors.").

[4] *See* Kenneth Ayotte & David A. Skeel, *Bankruptcy Law as a Liquidity Provider*, 80 U. CHI. L. REV. 1557, 1574 (2013) (discussing the shift in modern business practices of having multiple layers of secured debt).

[5] *See* Andrew A. Wood, *The Decline of Unsecured Creditor and Shareholder Recoveries in Large Public Company Bankruptcies*, 85 AM. BANKR. L.J. 429, 443 (2011) (offering an example of how this structure would adversely affect unsecured creditors).

entity.[6] The Bankruptcy Code (the "Code"),[7] however, has not kept pace with these changes in the capital landscape despite being amended a number of times since its enactment in 1978.[8] A number of commentators argue that the Code needs to be completely overhauled to reflect the new realities of junior secured debt and claims trading.[9]

Recently, after two years of study and review, the American Bankruptcy Institute Commission to Study the Reform of Chapter 11 (the "ABI Reform Commission") published its Final Report and Recommendations (the "ABI Report"), recommending that Congress enact a number of changes to the Code—many of which are tied to adjustments required by this shifting capital landscape.[10] The ABI Report noted that reforms were necessary given that companies are "working to find alternatives to filing bankruptcy cases, potentially at the expense of their creditors, shareholders, and employees" and that a "restructuring law that companies seek to avoid at all costs can exasperate companies' financial distress and negatively impact the overall economy."[11]

However, one aspect the ABI Report did not address is whether the Code's construct of the "official committee of unsecured creditors" (the "Unsecured Creditors' Committee"), and the related obligations of the bankrupt debtor to pay the fees and expenses of the Unsecured Creditors' Committee, remains an appropriate construct in this new landscape. We argue that the Code's current scheme of providing for an Unsecured Creditors' Committee and mandating that the estate pay its fees and expenses has, in many cases, fallen out of sync with modern economic realities and created perverse incentive structures. When the Code was enacted, the Unsecured Creditors' Committee represented core creditors entitled to significant distributions with a continuing interest in the debtor.[12] Today, in many

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[6] *See* Harvey Miller, *Chapter 11 in Transition – From Boom to Bust and Into the Future*, 81 AM. BANKR. L.J. 375, 390 (2007) ("Claims trading has dramatically changed the dynamics of the reorganization process. Distressed debt traders have different motivations and objectives than the old line relationship banks and trade creditors. Quick and significant return on investment is the imperative to the traders.").

[7] 11 U.S.C. §§ 101–1532 (2012).

[8] UNITED STATES COURTS, PROCESS - BANKRUPTCY BASICS, http://www.uscourts.gov/services -forms/bankruptcy/bankruptcy-basics/process-bankruptcy-basics.

[9] *See, e.g.*, Tally M. Wiener & Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 U. PENN. J. BUS. L. 35, 41 (observing that the Code does not regulate the transfer of claims); Kenneth A. Rosen, *Claims Trading Warps the Bankruptcy System*, WALL ST. J., Jan. 14, 2016 ("Despite [the] emergence of holders of claims who bought such claims at a deep discount, the bankruptcy code has never been amended to take this new reality into account."); Robert J. Keach & Albert Togut, *Commission to Explore Overhauling Chapter 11*, 5 AM. BANKR. INST. J., June 2011 at 36, 36–37 ("Since the Code's enactment, there has been an explosion in the use of secured credit, placing secured debt at all levels of the capital structure and trumping any long-term reorganization for the benefit of existing shareholders. The unparalleled expansion of distressed-debt markets and claims trading has made chapter 11 a financial and takeover play, minimizing the debtor's ability to control its own destiny.").

[10] *See* AM. BANKR. INST., COMM'N TO STUDY THE REFORM OF CHAPTER 11, 2012 ~ 2014 FINAL REPORT AND RECOMMENDATIONS 6 (2014).

[11] *Id.* at 11, 11 n.40.

[12] *See* H.R. REP. NO. 95-595, at 401 (1977).

cases, the Unsecured Creditors' Committee represents out-of-the-money creditors with no continuing interest in the debtor, seeking to extract value from secured creditors via hold-up tactics—frequently designed to flip a quick profit on claims acquired at a discount.[13] In these cases, despite the lack of entitlement to a recovery and the lack of any valid causes of action, the Unsecured Creditors' Committee continues to possess undue leverage on account of its entitlement to fee and expense reimbursement—with the perverse incentive of increasing that leverage by generating significant fees and expenses.[14] Such tactics greatly increase the cost of chapter 11 proceedings[15] and, in our view, deter companies and their secured creditors from using chapter 11, even though chapter 11 would be in the best interest of the parties.

Of course, the Unsecured Creditors' Committee itself remains a core aspect of the Code, in many cases providing critical service and representation of key constituents. It cannot simply be thrown out with the bath water. Instead, we suggest that, by altering the scheme of payment reimbursement applicable to the Unsecured Creditors' Committee, the Code could (i) align the leverage of the Unsecured Creditors' Committee with the entitlement of unsecured creditors to a recovery in a given case, (ii) stop the Unsecured Creditors' Committee from using procedural delay and fee generation in connection with meritless hold-up litigation as leverage (or to the benefit of the committee's professionals alone), and (iii) make chapter 11 a more efficient and attractive tool for corporate reorganization and value preservation. Absent changes to the Code, in the alternative, we suggest tailored drafting of "carve out" provisions in financing orders to limit the spending power of the Unsecured Creditors' Committee in out-of-the-money scenarios.

Section II of this Article provides an overview of the history of the Unsecured Creditors' Committee and its integration into the Code. Section III provides an overview of changed circumstances in the capital landscape that have resulted in the Unsecured Creditors' Committee, in some cases, having far more leverage than its out-of-the-money constituents should possess. Section IV proposes potential changes to the Code and other changes in practice that could realign incentives and rebalance the role of the Unsecured Creditors' Committee.

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[13] *See* Glenn E. Siegel, *Second Liens—Watching the Seconds Tick Away: Finding Value in Second Liens in Bankruptcy*, 1 BLOOMBERG CORP. L.J. 471, 476 (2006) (noting that cases involving second liens generally result in "committees [that] can be controlled by out of the money trade creditors whose only interest will be in delaying resolution of the case in order to receive a distribution").

[14] *See* AM. BANKR. INST., *supra* note 10, at 41–42 (discussing an Unsecured Creditors' Committee's right to reimbursement of professional fees).

[15] *See* AM. BANKR. INST., *supra* note 10, at 42 (discussing the potential costs and benefits associated with an Unsecured Creditors' Committee).

I. HISTORY OF THE UNSECURED CREDITORS' COMMITTEE

Prior to the enactment of the Code in 1978, business bankruptcies were generally governed by two different chapters of the Chandler Act of 1938.[16] Chapter X was enacted to deal with the reorganization of large public corporations.[17] Chapter X provided for the mandatory appointment of a reorganization trustee, a lengthy process for formulating a plan of reorganization under the active supervision of the Securities and Exchange Commission ("SEC"), and the impairment of secured and unsecured creditors and equity holders.[18] A creditors' committee was not available under chapter X.[19] In contrast to this lengthy process, chapter XI was enacted to provide an efficient and economical way for small businesses to restructure unsecured claims.[20] Chapter XI provided that managers could stay in control of the business without the appointment of a trustee and enjoy an unlimited exclusive right to formulate a plan of reorganization. It also provided that an official creditors' committee would be formed to negotiate the plan, but this committee did not have any authority to affect the rights of secured creditors.[21]

Corporate management's desire to avoid being replaced by a trustee, combined with the slow and cumbersome chapter X plan process involving the SEC, deterred many corporations from trying to reorganize under chapter X.[22] Instead, large corporations began reorganizing under chapter XI, notwithstanding that chapter XI was intended to apply only to small businesses.[23] Management of these large corporations remained in control of the business and formulated plans to restructure the unsecured debts of the corporation. Chapter XI plans were negotiated with

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[16] *See* Bankruptcy Act of 1898, amendments, Pub. L. No. 696, §§ 101–397, 52 Stat. 840 883–916 (1938) (detailing the procedures that govern business bankruptcies through chapters X and XI of the Bankruptcy Act).

[17] *See id.* at 52 Stat. 883 (introducing the procedures that govern large public corporation bankruptcies).

[18] Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 169 (2004) (explaining the statutory provisions of chapter X as containing "the mandatory appointment of a reorganization trustee[;] . . . an extended process for the development and promulgation of a plan or reorganization; the active participation of the SEC[;] . . . [and] permit[ing] impairment of rights of secured and unsecured creditors and stockholders . . .").

[19] *Id.* (stating that there was "no statutory appointment of official committees of creditors" available under chapter X).

[20] *See id.* at 170 ("Chapter XI was designed to provide an efficient, expeditious, economical vehicle for a small, generally privately-owned, business enterprise and an individual who desired to modify and discharge unsecured debts.").

[21] *Id.* ("The rigid requirements of Chapter X encouraged certain corporations to consider relief under another chapter of the Chandler Act, Chapter XI, which did not require the appointment of a trustee [and] permitted managers to stay in control . . . ." Furthermore, "Chapter XI did not provide any authority to affect the rights of secured creditors[,]" but rather "provided for the formation of a statutory or official creditors' committee to negotiate the arrangement of the unsecured debt." Lastly, "the debtor had an unlimited exclusive right to file a plan of arrangement" under this chapter).

[22] *See id.*

[23] *See id.*

official committees of unsecured creditors, which were usually comprised of bondholders and the largest trade creditors.[24]

When the Code was enacted in 1978, chapter X was abandoned, and chapter XI of the Chandler Act was replaced by the new chapter 11. Chapter 11 was similar to chapter XI, except that it permitted the debtor to restructure not only unsecured claims, but also all other claims against (including secured claims), and equity interests in, the corporation.[25] Section 1102(a) of the Code required mandatory[26] appointment of an Unsecured Creditors' Committee, whose attorneys' and other professionals' fees were required to be paid by the debtor's estate as an administrative expense.[27] Specifically, section 1103(a) of the Code permits the Unsecured Creditors' Committee to retain professionals, and section 330(a)(1) provides that "the court may award to . . . a professional person employed under section 327 or 1103 (A) reasonable compensation for actual, necessary services rendered by the . . . professional person, or attorney and by any paraprofessional person employed by any such person; and (B) reimbursement for actual, necessary expenses."[28]

The legislative history of section 1102(a) provides that the Unsecured Creditors' Committee "will be the primary negotiating bod[y] for the formulation of the plan of reorganization."[29] Although chapter 11 (as opposed to chapter XI) permits the debtor to restructure secured claims as well as unsecured claims, secured creditors are not permitted to serve on the Unsecured Creditors' Committee, nor is it mandatory—and indeed in practice it is extremely rare—that a committee of secured creditors be formed.[30] Apparently, Congress either incorrectly assumed that secured creditors would be paid in full in every case or decided that secured creditors could fend for themselves.[31]

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[24] *See id.* at 170–72.
[25] *See id.* at 176–77.
[26] The appointment of an Unsecured Creditors' Committee is mandatory so long as there are creditors willing to serve. *See* 7 COLLIER ON BANKRUPTCY ¶ 1102.02 (Alan N. Resnick & Henry J. Sommer eds., 16th ed. 2009); *cf. In re* Williams Comm. Grp., Inc., 281 B.R. 216, 223 (Bankr. S.D.N.Y. 2002) (noting that the appointment of an equity security holders committee is not mandatory and "should be the rare exception").
[27] *See* 11 U.S.C. § 330(a)(1) (2012); 11 U.S.C. § 1103(a) (authorizing an Unsecured Creditors' Committee to hire professionals).
[28] *See* 11 U.S.C. § 1103(a) (authorizing an Unsecured Creditors' Committee to hire professionals); 11 U.S.C. § 330(a)(1).
[29] H.R. REP. NO. 95-595, *supra* note 12.
[30] *See* 11 U.S.C. § 1102(a)(1), (b)(1) (authorizing the formation of a committee consisting of "creditors holding unsecured claims" who are "representative of the different kinds of claims to be represented"); *In re* Matter of Wekiva Dev. Corp. 22 B.R. 301, 302 (Bankr. M.D. Fla. 1982) (noting that it is extremely rare for secured creditors' interests to align); *see In re* Cumberland Farms, Inc., 142 B.R. 593, 595 (Bankr. D. Mass. 1992) (noting that secured creditors' claims are so individualistic that they are only minimally advanced by collective representation).
[31] *See* Douglas G. Baird & Robert K. Rasmussen, *Antibankruptcy*, 119 YALE L.J. 648, 656 (2010) [hereinafter Baird & Rasmussen, *Antibankruptcy*] ("Because the Code assumed that the secured creditors would be paid in full and the general creditors would receive the residual, the effect of having the debtor pay

The bankrupt debtor's estate is divided according to levels of priority set forth in the Code.[32] Generally, secured claims are first in line, followed by administrative expenses, which include the fees generated by professionals of the Unsecured Creditors' Committee.[33] Other priority claims follow administrative expenses.[34] General unsecured claims are last in line before equity and are to be treated with equal priority, irrespective of the nature of the underlying claim.[35] This hierarchy is reflected in section 1129(b)(2) of the Code and is informally referred to as the "absolute priority rule."[36] Under the absolute priority rule, a class of claims or interests that votes to reject a chapter 11 plan must receive payment in full; otherwise, the class junior to the rejecting class cannot receive a distribution under the plan.[37]

Thus, under the current scheme, the Unsecured Creditors' Committee's professional fees and expenses are paid by the bankrupt debtor as an administrative expense regardless of the extent to which (if at all) unsecured creditors are entitled to recover on their claims against the bankrupt debtor. To ensure that the limited resources of the bankrupt debtor are preserved, and that value is not unnecessarily destroyed, the Code must be amended to adapt to the appropriate role of the Unsecured Creditors' Committee when unsecured creditors are out-of-the-money.

II. CHANGED CIRCUMSTANCES HAVE ALTERED THE ROLE OF THE UNSECURED CREDITORS' COMMITTEE IN CHAPTER 11 CASES

There have been at least two major developments since the Code was enacted in 1978 that have significantly altered the typical role of the Unsecured Creditors' Committee.[38] First, the rise of distressed debt trading has changed the players in

was to spread the expenses among all of the general, unsecured creditors."). When the Code was enacted—at a time when the capital structures of large businesses were relatively simpler—the bankruptcy process was generally administered for the benefit of general creditors. *See id.* at 653 ("Action lay at the level of the general creditors. The bankruptcy was for the benefit of the general creditors. Hence, the drafters of the Bankruptcy Code provided that administrative expenses be paid after the secured creditors, but before the general creditors.").

[32] *See generally* 11 U.S.C. § 507.

[33] *See* 11 U.S.C. §§ 503(b)(2), 507(a)(1)–(2).

[34] *See* 11 U.S.C. § 507(a)(3)–(10).

[35] *See* 11 U.S.C. § 1129(b)(2).

[36] *See* Sara A. Austin, *New Value Exception: (Wanted) Dead or Alive — Viability of the "New Value" Exception to the Absolute Priority Rule Under Bankruptcy Code § 1129(b)(2)*, 96 DICK. L. REV. 189, 193 (1992).

[37] A bankruptcy court may approve a "cramdown" chapter 11 plan, notwithstanding that one or more classes votes to reject the plan, "if the plan does not discriminate unfairly, and is fair and equitable, with respect to each class of claims or interests that is impaired under, and has not accepted, the plan." *See* 11 U.S.C. § 1129(b)(1). The "absolute priority rule" is codified by way of the "fair and equitable" requirement. *See* 11 U.S.C. § 1129(b)(2)(B), (C) (explaining the "fair and equitable" requirement with respect to a class of unsecured claims and a class of interests).

[38] *See* AM. BANKR. INST., *supra* note 10, at 12

bankruptcy cases from those with a long-term relationship with the debtor to those who seek to make a quick buck.[39] Second, the creation and expansion of a junior secured debt market, together with a general shift in the economy to a service-based focus with less value tied up in hard assets (e.g., factories and equipment), has led to cash-flow based secured loans that almost always exceed the value of the borrower's hard assets and instead rely upon the going-concern sale of the business for repayment.[40]

A. *The Rise of Distressed Debt Trading*

At the time the Code was enacted in 1978, chapter 11 debtors generally had long-standing relationships with both their secured lenders and their vendors.[41] The secured lenders were normally commercial banks that had profitable cash-

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> [T]oday's financial markets, credit and derivative products, and corporate structures are very different than those existing in 1978 when Congress enacted the Bankruptcy Code. Companies' capital structures are more complex and rely more heavily on leverage, which is secured under state enactments of the Uniform Commercial Code that encumber vastly more assets than in 1978; their asset values are driven less by hard assets (e.g., real estate and machinery) and more by services, contracts, intellectual property, and other intangible assets; and both their internal business structures (e.g., their affiliates and partners) and external business models are increasingly multinational. In addition, claims trading and derivative products have changed the composition of creditor classes. Although these developments are not unwelcome or unhealthy, the Bankruptcy Code was not originally designed to rehabilitate companies efficaciously in this complex environment.

Id. (citation omitted); Ralph Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, 32 BANKR. L. LETTER No. 7, July 2012, at 15.

> Two monumental developments in Chapter 11 practice that the Code drafters likely did not anticipate, though, have skewed negotiations over allocation of reorganization surplus decisively in favor of senior secured creditors, in a manner that the Code drafters also likely did not anticipate. The first is the ascendancy of secured credit in Chapter 11 debtors' capital structures, such that it is now common that a dominant secured lender has blanket liens on substantially all of the debtor's assets securing debts vastly exceeding the value of the debtor's business and assets. The second related phenomenon is the rise of "relatively expeditious going-concern sales of the debtor's business and assets to a third-party purchaser" as a prominent means of realizing the debtor's going-concern value in Chapter 11.

Id. (citations omitted); Mark Jenkins & David C. Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization* 2, 3 (May 29, 2014), *available at* SSRN: https://papers.ssrn.com/sol3/papers.cfm?abstract_id =2444700 (paper presented at ABI Illinois Symposium on Chapter 11 Reform in May 2014) (draft on file with the ABI Reform Commission) ("Secured debt represented less than 45% of the debt of Moody's-rated firms filing for bankruptcy in 1991; by 2012, secured debt accounted for more than 70% of the debt of Moody's-rated bankruptcy filers.").

[39] *See* Miller & Waisman, *supra* note 18, at 181–82 (demonstrating the prior relationship between debtors and their creditors and the shift in relationship due to globalization and technology).

[40] *See* Miller & Waisman, *supra* note 18, at 183–84.

[41] *See* Miller & Waisman, *supra* note 18, at 181.

management, lockbox, and other relationships with debtors that might last for decades.[42] Vendors were often more interested in the debtors' continued existence as a customer than collecting overdue invoices.[43]

Today, secured and unsecured debt is often widely syndicated at the outset and sold to a large number of investors, and then in many cases purchased by so-called "distressed debt traders" at a substantial discount prior to the filing of a chapter 11 case.[44] The debt continues to trade during the bankruptcy case, with the price adjusting as new information comes to light at court hearings.[45] Because the claims-trading market is unregulated, there is a degree of uncertainty regarding its size, but it is estimated to be in the hundreds of billions of dollars.[46]

Many investors, including commercial banks, often choose to sell defaulted loans at a discount rather than carry them on their books or expend the resources required to actively undertake and participate in a bankruptcy process which, in many circumstances, may result in a substantial loss.[47] Vendors, never expecting to be long-term investors in a debtor even if they desire a long-term business relationship with the debtor, are similarly receptive to selling their claims at a discount rather than participating in a drawn-out bankruptcy process about which they often have little understanding.[48]

Purchasers of distressed debt seek to use their superior knowledge of the bankruptcy process to purchase debt claims at a substantial discount and make a quick profit by reselling the debt at a higher price or through distributions upon a sale or confirmation of a plan.[49] Purchasers of distressed debt may also purchase the

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[42] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 670.

[43] *See* Miller & Waisman, *supra* note 18, at 181 (explaining how vendors relied on one another for the business they generated and thus, long-lasting relationships were created which encouraged support between them).

[44] *See* Jonathan C. Lipson, *The Shadow Bankruptcy System*, 89 B.U. L. REV. 1609, 1645 (2009).

[45] *See id.* ("[T]rading can occur before or during bankruptcy.").

[46] *See id.* ("Being largely unregulated, it is difficult to estimate the size of this secondary market, but it is said to be in the hundreds of billions of dollars, if not more."); *see also* Hon. Robert D. Drain & Elizabeth J. Schwartz, *Are Bankruptcy Claims Subject to the Federal Securities Laws*, 10 AM. BANKR. INST. L. REV. 569, 576 (2002) ("[T]he multi-billion dollar claims trading market also has raised public policy concerns because it is largely unregulated by the SEC."); Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 BROOK. J. CORP. FIN. & COM. L. 67, 77 (2010) ("There is a broad consensus that there is a large and growing market in claims. Academic articles place the market at hundreds of billions.").

[47] *See* Miller & Waisman, *supra* note 18, at 181–82 (noting how financial institutions are often willing to sell the debt regardless of the relationships with the debtors and how they want a quick recovery of their claims, which could harm the debtors' ability to maintain their businesses and force them into bankruptcy again to pursue additional chapter 11 reorganizations).

[48] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 660 (discussing how claims trading allows holders of some claims, such as the suppliers of goods and services, an easy exit from reorganization process because they may be ill equipped to handle the reorganization due to the fact their businesses models may not focus on "tying up capital in bankruptcy proceedings").

[49] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 661 ("Either way, the new investor may be able to use its knowledge of the reorganization process to generate a higher return than could the party that owned the claim when the debtor filed for bankruptcy.").

debt to gain control of the business by insisting on equity distributions as part of plan negotiations.[50]

By contrast, when the Code was enacted in 1978, secured lenders were commercial banks who generally sought only to be paid principal and interest on their loans over a lengthy and predicable term.[51] Likewise, public bondholders were also generally assumed to be investing for the long term.[52] They were interested in the continued existence of the debtor and repayment of their restructured debt over time.[53] As one hedge fund manager explained: "In the old days, people wanted to see two things: to get paid and to see the company survive. Today people only want one thing: to get paid."[54]

Moreover, as distressed debt traders often buy claims at a substantial discount, these traders may prefer a quick liquidation or sale because it has less execution risk and still provides a healthy return on an already-discounted investment—even if a reorganization of the debtor with substantial reinvestment would ultimately lead to a more viable business and a higher recovery over time. One commentator has argued that the quick bankruptcies often forced by distressed debt traders may be a material cause of recidivism.[55]

B. *The Rise of Junior Lien Debt*

Prior to the early 2000s, secured lenders rarely consented to additional debt secured by junior liens.[56] Among other reasons, senior lenders did not want to contend with junior secured lenders when liquidating their collateral.[57] Banks and finance companies made senior secured loans; relatively passive savings-and-loan

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[50] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 661–62, 664 (discussing the Kmart reorganization, which the author called, "the most notable example of buying claims to obtain control of a company in bankruptcy. . . ," and how large creditors have the opportunity to battle for control of chapter 11 corporations and concurrently craft the reorganization plan).

[51] *See* Lipson, *supra* note 44, at 1661 ("Being heavily regulated, commercial banks . . . were only permitted to make 'safe and sound' loans which would amortize over a fairly lengthy and predictable term.").

[52] *See* Lipson, *supra* note 44, at 1661 ("Public investors—whether bondholders or stockholders—were also generally assumed to be investing for the long term.").

[53] *See* Lipson, *supra* note 44, at 1661–62 ("While bankruptcy reorganization would be a speed bump in that investment path, it did not necessarily alter the underlying time horizon.").

[54] Lipson, *supra* note 44, at 1662.

[55] Miller & Waisman, *supra* note 18, at 182 ("[D]istressed debt trading may be a material cause of recidivism, forcing reorganized debtor entities to return to the bankruptcy court to pursue another Chapter 11 reorganization effort.").

[56] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 672 (any additional financing was provided by savings-and-loan associations and insurance companies on an unsecured basis).

[57] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 673, 673 n.125 ("The concern [of first lien lenders] in times past has been that the existence of other secured creditors and their rights in collateral could result in complications for first lien lenders in the event of a workout or bankruptcy.") (quoting Marc Hanrahan & David Teh, *Second Lien Loans*, THE HANDBOOK OF LOAN SYNDICATIONS & TRADING 108, 112 (2006)) (internal quotations omitted).

and insurance companies provided unsecured mezzanine financing; and individual investors invested in unsecured bonds or equity.[58]

During the 2000s, borrowers began to access the difference between the senior secured loan and enterprise value through junior secured debt.[59] Between 2000 and 2007, the junior secured debt market experienced explosive growth.[60] Issuances rose from virtually zero in 2000 to a peak of $30 billion in 2007.[61] The junior secured debt market did not disappear after the 2008 financial crisis.[62] In 2012, there were $15 billion of junior secured debt issuances.[63] The growth of the junior debt market arose from a confluence of factors: (1) investment vehicles were formed to invest in secured debt, (2) investors were willing to take more risk than banks and finance companies in exchange for higher yields, (3) banks and finance companies collected fees for arranging senior secured facilities and junior secured facilities and selling them to these new investment vehicles, and (4) in light of the fees they were making for arranging multiple secured loan facilities and the additional liquidity such facilities provided borrowers, banks and finance companies were willing to overlook any additional difficulties that might arise from liquidating collateral securing both senior and junior debt.[64]

The junior secured lenders take a security interest in essentially the same assets as the senior secured lenders.[65] Unlike mezzanine lenders, the junior secured lenders' right to *payment* is usually not subordinated to the senior secured lenders' right to payment.[66] Rather, only the *liens* of the second lien lenders are subordinated.[67] Second lien debt investors, which consist mostly of hedge funds or similar investment funds, but typically not large commercial banks, have so far been

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[58] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 671–72.

[59] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 672.

[60] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 672; *see also* Miller, *supra* note 6, at 379 (discussing second lien lending's exponential growth between 2002 and 2007).

[61] *See* Dale A. Norton, *Increased Second Lien Activity Confirms Leveraged Loan Market Rally*, MKT. REALIST (Dec. 12 2012, 8:55 PM), http://marketrealist.com/2012/12/increased-second-lien-activity-confirms-leveraged-loan-market-rally (illustrating the extensive issuance of second lien loans).

[62] *See id.* (referring to the chart titled *Second Lien Loans Issuance* indicating that the issuances of second lien loans plummeted from $30 billion to $2 billion in 2009, but rallied to $15 billion by 2012).

[63] *See id.*

[64] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 659–60, 666–73 (discussing the different vehicles that developed for investing in the junior debt market, like syndicated loans and claims trading, and the tangible benefits to hedge funds and other investors that come along with investing in this market).

[65] Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 672 (stating that the secondary lender takes a security interest in the same assets as the first lender).

[66] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 672 (explaining that the secondary lender has essentially the same right to be repaid as the primary lender for junior secured debt unlike junior unsecured debt).

[67] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 672 (providing that second liens are "second only in terms of their claim on the collateral package").

very aggressive in seeking to skirt their obligations under intercreditor agreements in bankruptcy cases.[68]

Due to the rise of the second lien (or even third lien) debt market, companies can often obtain "secured" financing equal to the estimated going concern value of the company itself.[69] With bankruptcy generally viewed as a last resort, distressed companies will usually obtain additional secured debt if there is any opportunity to do so—often to the point that such companies become over-leveraged and the secured lenders capture any remaining corporate value.[70] As a result, in many restructuring or bankruptcy scenarios, there is no distributable value of the bankrupt debtor beyond the secured debt to pay administrative expenses and priority claims, much less unsecured claims.[71] In response to these changing circumstances, bankruptcy courts now generally require senior secured lenders to "carve out" from their liens sufficient value to fund the cost of the bankruptcy proceeding.[72] This includes an amount to fund the fees of the professionals of the Unsecured Creditors'

[68] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 673–74 (reiterating that hedge funds that own second lien debt "are not shy about testing the limits of the intercreditor agreement"); *see also In re* Boston Generating, LLC, 440 B.R. 302, 320 (Bankr. S.D.N.Y. 2010) (finding that the intercreditor agreement did not prohibit the junior secured creditors from objecting to the sale of substantially all of the debtors' assets); *see* Order (A) Authorizing and Approving the Sale of Assets Free and Clear of All Liens, Claims, Encumbrances, and Other Interests, (B) Authorizing and Approving the Assumption and Assignment of Executory Contracts and Unexpired Leases, and (C) Granting Related Relief at 4–6, 29, *In re* CyberDefender Corp. (Bankr. D. Del. 2012) (No. 12-10633-BLS) (order authorizing and approving the sale of assets free and clear of all liens, claims, encumbrances, and other interests); *see also In re* Metaldyne Corp., No. 09-13412, 2009 WL 2883045, at *4 (Bankr. S.D.N.Y. June 23, 2009) (limiting enforcement of the intercreditor agreement's adequate protection provisions); Fourth Interim Order (1) Authorizing Debtors to Use Cash Collateral, and (2) Granting Adequate Protection to Prepetition Senior Lenders and Prepetition Junior Lenders, and Order Converting Cases to Chapter 7 at 2, 5, *In re* Am. Remanufacturers*,* 451 B.R. 349 (Bankr. D. Del. 2011) (No. 05-20022-PJW) (converting case to chapter 7 liquidation after agreeing with second lien lenders' objection to debtor-in-possession financing package offered by first lien lenders, who withdrew their financing offer after the second lien lenders' opposition thereto).

[69] *See* Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 STAN. L. REV. 751, 786 (2002) [hereinafter *The End of Bankruptcy*] (explaining how companies have long relied on going-concern sales).

[70] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 673 (observing that "[g]ranting a lien has consequences. . . . A second lien holder, by virtue of its lien, can grab its collateral. After a bankruptcy petition has been filed, it can object to the use of its collateral and seek adequate protection of its interest").

[71] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 674, 674 n.133 (discussing that because secured creditors receive the value of their collateral first, cases are considered to be "administratively insolvent" when there are insufficient funds to then pay for the costs of the reorganization); *see generally* 11 U.S.C. §§ 506–507 (2012).

[72] *See* Sally McDonald Henry, *Paying-To-Play in Chapter 11*, 17 J. BUS. & SEC. L. 113, 126 (2017) ("In effect, the carve out is a negotiated provision for a surcharge that will kick in without litigation in the worst case scenario."); Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 AM. BANKR. L.J. 445, 451 (2002) ("The carve out becomes important to the protected administrative claimants only when the unencumbered assets in the bankruptcy estate that remain after application of the collateral proceeds to the secured claim are not adequate to pay all administrative claims, so that the administrative claimants will need to look to the carve out as an alternative source for payment.").

Committee.[73] Bankruptcy courts typically warn senior secured lenders that they will dismiss the chapter 11 case if the senior secured lenders do not provide a sufficient "carve out" to "pay the freight" of the chapter 11 case and assure it is not administratively insolvent.[74] Senior secured lenders usually limit the "carve out" amounts available to the debtors' professionals and the Unsecured Creditors' Committee's professionals pursuant to a budget.[75]

However, a plan of reorganization cannot be confirmed unless all administrative claims and priority claims are paid in full.[76] Accordingly, if a debtor is to reorganize through a plan of reorganization, all of the fees of the debtor professionals and committee professionals must be paid, even if they far exceed the "carve out" amounts agreed to with the senior secured lenders. This has likely led to the increasing trend of debtors in many chapter 11 cases quickly selling their assets under section 363 of the Code—with all proceeds (less the carve-out for administrative expenses) going to secured lenders—and converting their cases to chapter 7 due to a lack of sufficient funds being available to pay all administrative and priority claims under a chapter 11 plan.[77]

C. The New Role of the Unsecured Creditors' Committee

The rise of junior secured debt has caused unsecured creditors to be out-of-the-money in many cases by the time a bankruptcy is commenced.[78] Combined with the rise in claims trading, this has caused the Unsecured Creditors' Committee to often be dominated in larger cases by distressed debt traders who paid pennies on the

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[73] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 674–75 (stating "[b]ut a practice has emerged in which the secured creditor agrees to 'carve out' a part of its lien to fund the costs of running the proceeding").

[74] *See* The Official Committee of Unsecured Creditors' Objection to the Debtors' Motion for Entry of Interim and Final Orders Pursuant to 11 U.S.C. §§ 105, 361, 362, 363, 364, AND 507 and Fed. R. Bankr. P. 2002, 4001 and 9014 (I) Authorizing Debtors and Debtors in Possession to Obtain Postpetition Financing, (II) Authorizing Use of Cash Collateral, (III) Granting Liens and Super-Priority Claims, (IV) Granting Adequate Protection to Prepetition Secured Lenders, (V) Modifying the Automatic Stay, (VI) Scheduling a Final Hearing, and (VII) Granting Related Relief at 11–12, *In re* Draw Another Circle, LLC (Bankr. D. Del. filed Jul. 20, 2016) (No. 16-bk-11452-KJC), ECF No. 416.

[75] *See* Levin, *supra* note 72, at 445 ("The [carve out] agreement, which is subject to court approval, usually limits the nature, amount, and timing of expenses covered, often by reference to a budget.").

[76] *See* 11 U.S.C. § 1129(a)(9)

> Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the plan provides that— (A) with respect to a claim of a kind specified in section 507(a)(2) or 507 (a)(3) of this title, on the effective date of the plan, the holder of such claim will receive on account of such claim cash equal to be allow amount of such claim.

Id.

[77] *See* Baird & Rasmussen, *The End of Bankruptcy, supra* note 69, at 751–53 ("Corporate reorganizations have all but disappeared.").

[78] *See Siegel, supra* note 13 and accompanying text.

dollar for unsecured debt in the hope that they can "greenmail" the secured creditors into providing them a recovery in excess of their investment, regardless of whether such a distribution would be appropriate in light of the absolute priority rule.[79] All administrative expenses, including the fees of the professionals for the Unsecured Creditors' Committee, must be paid in full to confirm a plan under section 1129 of the Code.[80] As a result of this leverage, an Unsecured Creditors' Committee may elicit a "gift" from the class of secured creditors, especially when the confirmability of a chapter 11 plan is in doubt.[81]

In certain cases, it appears that committee professionals have employed a strategy of running up enormous professional fees investigating every possible cause of action against management and the secured lenders and threatening to embroil them in even more expensive litigation of those issues, regardless of the merits. They often do not relent unless the debtors make, and the secured lenders consent to, a distribution to unsecured creditors to which they are not otherwise entitled—in addition to the payment of the significant professional fees incurred by the Unsecured Creditors' Committee.[82] Debtors and secured lenders are then faced with three choices: (1) liquidate, (2) sell the business under section 363 of the Code and then convert the case to chapter 7, or (3) negotiate a "settlement" of the baseless

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[79] *See* Levitin, *supra* note 46, at 97 ("[T]here are greenmailers who accumulate enough claims of a particular impaired class to block plan confirmation. Greenmailers play on hostage value, using this blocking position to extract a greater payout in a plan of reorganization for their class of claims or to get bought out.").

[80] 11 U.S.C. § 1129(a)(4).

[81] *See In re* ICL Holding Co., Inc., 802 F.3d 547, 549, 555–57 (3d Cir. 2015) (holding that cash payments escrowed by secured lenders for professional fees and paid directly to unsecured creditors did not violate the Code's absolute priority rule, as neither of the two payments went into or came out of the bankruptcy estate). The *ICL Holding* court made the following observation regarding the deal reached with unsecured creditors:

> As is not uncommon . . . , and before its objections to the sale reached resolution, the Committee struck a deal with the secured lender group. In exchange for the Committee's promise to drop its objections and support the sale, the secured lenders agreed to deposit $3.5 million in trust for the benefit of the general unsecured creditors.

Id. at 551.

[82] *See* Notice of Designation as Complex Chapter 11 Bankruptcy Case at 2, *In re* Midstates Petroleum Co. (Bankr. S.D. Tex. 2016) (No. 16-32237-DRJ) (the committee's attempt to obtain standing to bring unmeritorious causes of action drew the ire of the presiding judge); *see also* Jacqueline Palank, *Bankruptcy Judge Rebukes Squire Patton Boggs*, WALL ST. J. L. BLOG, (Sept. 29, 2016), https://blogs.wsj.com/law/2016/09/29/bankruptcy-judge-rebukes-squire-patton-boggs/.

> The judge took issue with the committee's motion, filed by Squire Patton Boggs, declaring its intent to sue senior Midstates creditors, as well as Midstates officers and directors, for allegedly trying to defraud unsecured creditors. Midstates and the creditors denied the allegations and fought the motion, which Midstates in court filings called 'long on inflammatory allegations' and 'short on evidence.' Judge Jones came to view the allegations as false. No lawsuit has been filed.

Id.

lawsuits that may be distributed to unsecured creditors so that a plan may be confirmed.[83] Even if secured lenders decide to liquidate or sell the business under section 363 of the Code, the Unsecured Creditors' Committee's complaints may scare off potential purchasers and result in reduced recoveries for "in-the-money"[84] secured creditors.

Changes in the litigation landscape have exacerbated the "holdup" leverage available to the Unsecured Creditors' Committee, given that the bankrupt debtor is responsible for both sides of the litigation expense.[85] Litigation costs and exposures are aggravated by so-called "e-discovery"—discovery of electronically stored information and documents—which over the past decade, has vastly inflated the cost of discovery, increasing leverage for "weak, meritless, and even frivolous claims."[86] "By some estimates, discovery costs now comprise between 50 and 90 percent of the total litigation costs in a case," and "[c]ounsel now recognize that electronically stored information is useful not only as a litigation tool, but also as a litigation tactic."[87] An Unsecured Creditors' Committee, according to some courts, may also gain access to documents that a bankrupt debtor would otherwise withhold from production based on the attorney-client privilege, so long as the Unsecured

[83] *See* Czyzewski v. Jevic Holding Corp., 137 S. Ct. 973, 979 (2017) (describing the three possible conclusions to a chapter 11 bankruptcy).

[84] *See In re* Thomas, 91 B.R. 731, 737 (Bankr. N.D. Tex. 1988) (explaining that the United States agencies are "in the money" because they are secured creditors); *see also In re* PTL Holdings LLC, No. 11-12676 BLS, 2011 WL 5509031, at *1–2 (Bankr. D. Del. Nov. 10, 2011) (explaining that when a secured creditor cannot recover its entire claim under a proposed reorganization plan, the plan cannot be approved because a secured creditor's claim is protected or guaranteed—it is "in the money").

[85] *See In re* DPH Holdings Corp., 553 B.R. 20, 24–25 (Bankr. S.D.N.Y. 2016) (acknowledging the "holdup" leverage creditors may assert by contesting the confirmation of a reorganization plan); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. OF LEGAL ANALYSIS 511, 538–39 (2009) (concluding that chapter 11 gives unsecured creditors leverage over resource allocation and the reorganization process).

[86] *See* Karel Mazanec, *Capping E-Discovery Costs: A Hybrid Solution to E-Discovery Abuse*, 56 WM. & MARY L. REV. 631, 632 (2014); *see also* John H. Beisner, *Discovering a Better Way: The Need for Effective Civil Litigation Reform*, 60 DUKE L.J. 547, 549–51 (2010) (explaining that e-discovery has opened the door for attorneys to employ abusive tactics intended to coerce settlement).

[87] Beisner, *supra* note 86, at 549, 570.

> The additional costs associated with production of electronic records can be considerable. One expert estimates the cost of producing a single electronic document to be as high as $4. Verizon, which has devoted considerable attention to electronic discovery issues, has estimated that producing one gigabyte of data—the equivalent of between 15,477 and 677,963 printed pages—costs between $5,000 and $7,000. But far more than a single gigabyte of data will often be at issue. Commentators opine that even a typical midsize case now involves at least 500 gigabytes of data, resulting in costs of $2.5 to $3.5 million for electronic discovery alone. Another study found that from 2006 to 2008, the average surveyed company spent between $621,880 and $2,993,567 per case on electronic discovery. At the high end, companies in the study reported average per-case discovery costs ranging from $2,354,868 to $9,759,900.

Id. at 566–67 (internal citations omitted).

Creditors' Committee proves that the bankrupt debtor was insolvent when the privileged communications took place.[88] Given that a bankrupt debtor's solvency is a moot point when an Unsecured Creditors' Committee represents out-of-the-money unsecured creditors, the Unsecured Creditors' Committee in such cases will have even more leverage to extract settlement value.

The recent opinion of the Bankruptcy Court for the District of Delaware in *In re Molycorp Inc.* shows how an Unsecured Creditors' Committee can extract settlement value and generate substantial professional fees that become a "toll" to be paid on the road to confirming a chapter 11 plan.[89] The *Molycorp* decision highlights some of the unfortunate burdens imposed on the bankrupt debtor's estate when an Unsecured Creditors' Committee goes on the war path notwithstanding ostensible limits on its spending power.[90] The debtors in *Molycorp* obtained Debtor-in-Possession ("DIP") financing from a DIP lender.[91] The applicable financing order carved out $250,000 from the DIP loan proceeds and collateral securing the DIP loan for the maximum aggregate amount of fees that could be incurred by the Unsecured Creditors' Committee in the course of investigating the DIP lender's transactions with the debtors and the debtors' adequate protection obligations with respect to the DIP lender's liens.[92] After obtaining standing, the Unsecured Creditors' Committee brought claims against the DIP lender, alleging fraud and "loan-to-own" tactics by the DIP lender.[93] The litigation culminated in a settlement agreement between the DIP lender and the Unsecured Creditors' Committee.[94]

After the dust had settled, the Unsecured Creditors' Committee had incurred approximately $8.5 million in professional fees and expenses.[95] Counsel for the Unsecured Creditors' Committee filed an interim fee application for its fees and expenses following confirmation of the debtors' reorganization plan.[96] The DIP lender objected to the requested fees, arguing primarily that the fees ran afoul of the carve-out in the financing order.[97]

In his opinion, Judge Christopher Sontchi determined that the applicable carve-out did not operate as a complete bar against the allowance of administrative claims following plan confirmation and that counsel was entitled to payment of the fees.[98]

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[88] *See, e.g., In re* HH Liquidation, LLC, 571 B.R. 97, 104–05 (Bankr. D. Del. 2017) (holding that a finding of insolvency "is the key" to determining whether a committee may access privileged documents after obtaining derivative standing to pursue causes of action belonging to the bankruptcy estate).

[89] *See In re* Molycorp, Inc., 562 B.R. 67, 70–71 (Bankr. D. Del. 2017) (approving Committee's fees for over $8 million plus additional fees).

[90] *See generally id.*

[91] *See id.* at 71–72.

[92] *Id.* at 74.

[93] *See id.* at 72.

[94] *See id.*

[95] *See id.* at 73.

[96] *See id.*

[97] *See id.*

[98] *See id.* at 79–80, 82–83.

Rather than a complete bar on professional fees in excess of $250,000, the carve-out, according to Judge Sontchi, "capped [the DIP lender]'s exposure and liability to payment of certain administrative expenses *in case no reorganization plan had been executed*."[99] Had a plan not been confirmed and had the bankrupt debtors' estates become administratively insolvent, the $250,000 cap would have resulted in the committee's counsel not being compensated for the work it had performed.[100] However, a plan *was* confirmed.[101] Thus, the fees incurred by the committee, to the extent such fees were allowed as administrative expenses (which they were), had to be paid by the debtors pursuant to section 1129(a)(9)(A) of the Code.[102] The opinion did not provide any guidance on whether a *per se* disallowance of administrative claims in a financing order carve-out would be effective or proper under the Code.[103]

The facts of *Molycorp* are unfortunately not unusual and demonstrate that a standard carve-out provision will not necessarily deter an Unsecured Creditors' Committee from incurring significant professional fees. Based on *Molycorp*, a standard carve-out provision appears to do nothing more than reorder priorities in the event of administrative insolvency.

III. HOW TO STOP "OUT-OF-THE-MONEY" UNSECURED CREDITORS FROM HOLDING THE BANKRUPTCY PROCESS HOSTAGE

This cannot be the role that Congress envisaged for the Unsecured Creditors' Committee when it enacted section 1102(a) of the Code in 1978 and said that the Unsecured Creditors' Committee "will be the primary negotiating bod[y] for the formulation of the plan of reorganization."[104] Indeed, the ABI Report noted that certain commissioners "felt that the mandatory nature of a committee of unsecured

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[99] *Id.* at 77 (emphasis added) ("[P]aragraph 4(b) of the DIP Financing Order reflects Oaktree's consent to payment of certain administrative expenses and imposes a limit on the amount of its collateral which may be used to pay the attorneys employed by the Committee . . . .").

[100] *See id.* (finding the possibility of Paul Hastings not being compensated for the work it performed was a conscious risk that the Committee's Counsel took).

[101] *See id.*

[102] *Id.* at 82–83 (adopting "the recommendations set forth in the Fee Examiner's Report, approving Paul Hastings' fees in the amount of $8,461,396.25 and reimbursement of expenses in the amount of $225,820.83").

[103] *Cf.* Omnibus Response of Official Committee of Unsecured Creditors and Paul Hastings to Oaktree's Objections to Paul Hastings' Fee Applications at 29, 29 n.65, *In re* Molycorp, Inc., 562 B.R. 67 (Bankr. D. Del. 2017) (No. 15-11357-CSS); *see also* Final Order (I) Authorizing Debtors (A) To Obtain Post-Petition Financing Pursuant to 11 U.S.C. §§ 105, 361, 362, 364(C)(1), 364(C)(2), 364(C)(3), 364(D)(1), and 364(E) and (B) To Utilize Cash Collateral Pursuant to 11 U.S.C. § 363, and (II) Granting Adequate Protection to Pre-Petition Secured Parties Pursuant to 11 U.S.C. §§ 361, 362, 363, and 364 at 17–19, 33–35, 44–46, *In re* Granite Bd. Corp. (Bankr. S.D.N.Y. 2007) (No. 06-12984-ALG) (upholding disallowance of administrative claims provision in DIP order).

[104] H.R. REP No. 95-595, *supra* note 12, at 401 (explaining the purpose of Creditors' and Equity Security Holders' Committees).

creditors was no longer warranted given that the fulcrum claims are now secured claims in many debtors' capital structures."[105] Yet, other commissioners believe the oversight function performed by the Unsecured Creditors' Committee merited its preservation.[106] Ultimately, the ABI Reform Commission decided that, in large part, mandatory appointment of an Unsecured Creditors' Committee (absent "cause" not to) should be preserved, specifically noting the utility of the "watchdog" function and that "unlike secured or administrative creditors—whose claims must be paid to confirm a plan—the Bankruptcy Code does not mandate any minimum return for general unsecured creditors (other than that they receive more than they would in a chapter 7 liquidation)."[107] The ABI Reform Commission specifically considered "cases in which tactics by a committee can increase costs or delay the resolution of a case or a material transaction in the case" and found that, despite some commissioners' position that these tactics were infrequent, they could nonetheless harm the estate and its constituents.[108]

Notwithstanding the foregoing, the ABI Reform Commission ultimately concluded that "the court and the U.S. Trustee have sufficient authority under the law to monitor the activity of unsecured creditors' committees and to implement appropriate protections as needed."[109] The ABI Reform Commission, however, did not consider more modest alternatives to eliminating the mandatory nature of the Unsecured Creditors' Committee. As discussed below, we suggest reforms that will strike the appropriate balance between the positives and negatives of having a mandatory Unsecured Creditors' Committee. The "watchdog" function of an Unsecured Creditors' Committee would be preserved, allowing the Unsecured Creditors' Committee to investigate and pursue potentially meritorious claims arising from wrongdoing committed by a bankrupt debtor's management or its secured lenders. The current perverse incentive structure, however, would be removed, so that in the event causes of action are weak or baseless, the Unsecured Creditors' Committee would be deterred from pursuing them and needlessly generating professional fees in a quest for leverage.

In light of modern economic realities and the importance of promoting a more equitable and cost-effective administration of chapter 11 estates, especially when unsecured creditors are out-of-the-money, the authors propose both statutory and

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[105] AM. BANKR. INST., *supra* note 10, at 41 (describing the discourse regarding the value of unsecured creditors' committees in chapter 11 cases).

[106] *See* AM. BANKR. INST., *supra* note 10, at 41.

[107] AM. BANKR. INST., *supra* note 10, at 42.

[108] AM. BANKR. INST., *supra* note 10, at 42 (providing background on the ABI Reform Commission's decision).

[109] AM. BANKR. INST., *supra* note 10, at 42. The ABI Report also contemplated revisions to the Code to facilitate stricter review of the fees of both debtor and committee professionals and "reduce requested fees for actions that dissipated the value of the estate." *Id.* at 64. However, ultimately the ABI Report did not recommend any revisions on this point, in part due to the "lack of objective data and academic literature evaluating the advantages and disadvantages of such a review process." *Id.*

contractual changes: the former entails a rejiggering of statutory priorities, and the latter envisions more focused drafting of carve-outs in financing orders.

A. Amending the Bankruptcy Code

The professional fees of the Unsecured Creditors' Committee should no longer stand in the way of confirming a chapter 11 case. To address this problem and reorient economic incentives under the Code, professional fees generated by the Unsecured Creditors' Committee should be relegated to a level of priority ahead of general unsecured claims but behind existing administrative and priority claims. In business bankruptcy cases, section 507(a)(2) of the Code grants the highest degree of priority to unsecured claims that constitute administrative expenses.[110] The authors suggest the following changes: (i) excepting professional fees of the Unsecured Creditors' Committee from section 503(b) and section 507(a)(2); and (ii) according lower priority status to such fee claims so they need not be paid as a prerequisite to confirmation of a plan.[111]

The foregoing statutory change would align the leverage of the Unsecured Creditors' Committee with its corresponding place in a given capital structure. Moreover, it is effectively the same scenario in which junior secured lenders currently find themselves: their fees will be paid only to the extent their class recovers or an agreement is otherwise reached. Particularly as secured financing arrangements have become increasingly syndicated and widely traded,[112] junior secured lenders are often nearly as numerous as unsecured debt holders.[113] Yet, where and when merited, junior secured lenders have managed to take active roles in bankruptcy cases without being legally assured that the bankrupt debtor's estate will fund the costs of their professionals.[114]

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[110] *See* 11 U.S.C. § 507(a)(2) (2012) (granting highest priority to "administrative expenses allowed under section 503(b)" of the Code).

[111] Some may argue that this proposal swings the pendulum too far in favor of secured creditors and may make it difficult or impossible to negotiate a reasonable carve-out for the professional fees incurred by an Unsecured Creditors' Committee. Under such circumstances, the Unsecured Creditors' Committee may lack the ability to retain professionals that are willing to serve on a contingency basis or otherwise. This issue could be addressed by retaining limited administrative expense priority status for a modest amount (*e.g.*, $25,000 to $250,000, depending on the size of the case) to at least enable the Unsecured Creditors' Committee's professionals to investigate whether there is a potential recovery for unsecured creditors. The remainder of the Unsecured Creditors' Committee's expenses would receive priority behind administrative expenses and other priority claims but ahead of general unsecured claims.

[112] *See* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 667–69 (discussing risk-reducing effect of syndication and observing that the composition of lending syndicates has evolved over time).

[113] *See* Siegel, *supra* note 13, at 471 (stating that second lien debt has risen from approximately $3 billion in 2003 to $16.3 billion in 2005).

[114] *See* Siegel, *supra* note 13, at 476 (stating that "the ability of a second lienholder to act passively and rely on others to maximize its recovery [is] severely limited"); *see also* Baird & Rasmussen, *Antibankruptcy, supra* note 31, at 675 ("If the second lien position is the fulcrum security . . . then the reorganization is being run for the second lien lenders' benefit and they should pay for it.").

B. Drafting "Carve-Out" Provisions with Teeth

If the foregoing proposed statutory reform does not come to fruition, the undue leverage of the Unsecured Creditors' Committee in out-of-the-money scenarios could be curbed as a contractual matter. Bankruptcy courts still might force, and an Unsecured Creditors' Committee may negotiate for, a reasonable "carve-out" for a budgeted amount of professional fees, and their flexibility to do so should not be curtailed. Rather, the ability of an Unsecured Creditors' Committee to pursue baseless litigation and run up enormous, unreasonable fees—in excess of the negotiated "carve-out"—that must be paid to confirm a chapter 11 plan should end in cases where unsecured creditors are out-of-the-money.[115]

As discussed above, unless a financing order contains express language providing for an absolute cap on the allowance of administrative expenses, a standard carve-out provision will not cap professional fees of an Unsecured Creditors' Committee in cases where a plan is confirmed.[116] To short circuit the spending power of the Unsecured Creditors' Committee, secured lenders should insist on more aggressive and tailored language in carve-out provisions. Specifically, carve-outs should be crafted so that professional fees of the Unsecured Creditors' Committee in excess of a fixed dollar amount shall not be allowed as administrative expenses under section 503(b) or for purposes of section 1129(a)(9) of the Code.

To ensure that this contractual workaround is enforceable, however, carve-out language must comply with the exception set out in the preamble to section 1129(a)(9).[117] Alternative treatment of administrative expenses, after all, may only be approved after obtaining the affected administrative claimant's agreement.[118]

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[115] Notably, bankruptcy courts typically deny requests for the appointment of equity security holders committees when shareholders are out-of-the-money. *See, e.g., In re* SunEdison, Inc., 556 B.R. 94, 102–03 (Bankr. S.D.N.Y. 2016) (noting that "the stockholders of a 'hopelessly insolvent' estate have no economic interest in the case," and that under such circumstances, "the estate should not have to bear the expense of negotiating with an Equity Committee over what amounts to a gift").

[116] *See In re* Molycorp, Inc., 562 B.R. 67, 80 (Bankr. D. Del. 2017) (reasoning that the failure to include a disallowance provision in the DIP financing order "speak[s] for itself"); *see also* Levin, *supra* note 72, at 446 (noting that carve-out provisions "seldom address the way the carve out should operate when it is most needed, that is, when the debtor's operating cash flow and unencumbered assets are inadequate to pay all administrative expenses").

[117] *See* 11 U.S.C. § 1129(a)(9) (2012) (requiring administrative expenses and other priority claims to be paid in full, "[e]xcept to the extent that the holder of a particular claim has agreed to a different treatment of such claim").

[118] *See In re* Molycorp, Inc., 562 B.R. at 78 (expressing concern that the Code "does not state the form which a consent to a different treatment must be given, nor does it indicate the time or stage in a Chapter 11 case that such consent may be obtained"). Courts are divided regarding whether this requires a creditor to expressly consent to a different treatment, or whether consent may be implied from the creditor's conduct. *Compare In re* Teligent, Inc., 282 B.R. 765, 770–73 (Bankr. S.D.N.Y. 2002) (finding consent to lesser treatment when administrative creditors had not returned a ballot in an administratively insolvent case), *with In re* Cummins Util., L.P., No. 01-47558-DML-11, 2003 Bankr. LEXIS 2309, at *9–10 (Bankr. N.D. Tex. Apr. 16, 2003) (holding that section 1129(a)(9)(A) of the Code requires express consent to a different

Thus, to obtain an ironclad agreement to alternative treatment, the enhanced carve-out provision and a stipulation of agreement should be negotiated directly with professionals retained by the Unsecured Creditors' Committee.

CONCLUSION

The Code has not kept pace with the rapid changes in corporate capital structures. As a result of the changing landscape and incentive structure, the modern-day Unsecured Creditors' Committee—often consisting of out-of-the-money unsecured creditors—extracts value from secured lenders in exchange for settling what in many cases are unmeritorious causes of action brought on behalf of the bankrupt debtor's estate. The substantial fees generated by the Unsecured Creditors' Committee in pursuit of these causes of action should no longer be a "price of admission" for confirming a chapter 11 plan. The authors believe that legislative modifications and more artfully drafted carve-out provisions will create more appropriate economic incentives for an Unsecured Creditors' Committee. In turn, the bankruptcy process would no longer be held hostage by out-of-the-money creditors and would become a more efficient and viable platform for the reorganization and going-concern sale of insolvent businesses.

treatment), *and In re* Real Wilson Enters., No. 11-15697-B-11, 2013 WL 5352697, at *8 (Bankr. E.D. Cal. Sept. 21, 2013) (concluding that "courts requiring affirmative consent have the better interpretation of 'agreed'").