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INTRODUCTION*

A robust, effective, and efficient bankruptcy system rebuilds companies, preserves jobs, and facilitates economic growth with dynamic financial markets and lower costs of capital. For more than 35 years, the U.S. Bankruptcy Code has served these purposes, and its innovative debtor in possession chapter 11 process, which allows a company to manage and direct its reorganization efforts, is emulated around the globe. As with any law or regulation, however, periodic review of U.S. bankruptcy laws is necessary to ensure their continued efficacy and relevance.

Whether by design or chance, efforts to review and assess U.S. business reorganization laws are undertaken approximately every 40 years. Such efforts have led to federal legislation effecting meaningful revisions to business reorganization laws in 1898, 1938, and 1978. It may be that four decades is the maximum amount of time that any financially driven regulation can remain relevant. Markets and financial products, as well as industry itself, often evolve far more quickly than the regulations intended to govern them. It may be that significant economic crises tend to occur cyclically and encourage reevaluation of the federal bankruptcy laws. Regardless, the general consensus among restructuring professionals is that the time has come once again to evaluate U.S. business reorganization laws. Accordingly, the American Bankruptcy Institute (the "ABI") established the Commission to Study the Reform of Chapter 11 (the "Commission") for this precise purpose.

The Commissioners are among the most prominent insolvency and restructuring practitioners in the United States, who have represented debtors, creditors, and other stakeholders, such as private equity investors, in the largest and most significant cases in U.S. history. The Commissioners included the Chair and former Chair of the influential National Bankruptcy Conference, the immediate past Chair and former President of the prestigious American College of Bankruptcy, two past Chairs of the New York City Bar Committee on Bankruptcy and Reorganization, the former Chief Restructuring Officer of the United States Treasury, a past Chair of the Turnaround Management Association, three prominent turnaround consultants, a past member of the National Bankruptcy Review Commission, a former Chief Bankruptcy Judge of the Southern District of New York, the two principal draftsmen of the 1978 Bankruptcy Code, several past members of the Advisory Committee on Bankruptcy Rules of the Judicial Conference of the United States, the current President of INSOL International, the Director of the Executive Office for U.S. Trustees in the Department of Justice,[1] five past Presidents of the American Bankruptcy Institute, and nine current and former global heads of the bankruptcy departments at major U.S. law firms. The

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* [Eds. note - This is an abridged and lightly edited version of the American Bankruptcy Institute Commission to Study the Reform of Chapter 11: 2012~2014 Final Report and Recommendations, which was originally released on December 8, 2014. The original and complete Report is available at https://abiworld.app.box.com/s/vvircv5xv83aavl4dp4h. The portions of the Report included here are Sections I–VII, and the Conclusion. The Appendices are not reprinted here and thus, the reader is directed to the original Report where any reference to Appendices occur. Any references to Sections within the Report are also directed toward the original Report. The *American Bankruptcy Instiute Law Review* is not responsible for the accuracy of the citations or sources found within this Report.]

[1] As a nonvoting member, Director Cliff White took no position on legislative proposals. Mr. White provided institutional perspectives and technical assistance on issues considered by the Commission.

Commissioners and their full professional biographies, as well as that of the Reporter, are attached collectively at Appendix A.

In assembling those who would serve as Commissioners and as members of the topical advisory committees, special attention was paid to the fact that although large cases capture headlines, the overwhelming number of business bankruptcies are by small and medium-sized enterprises. Professionals with unique experiences in these kinds of cases lent their special expertise to the Commission process. As a result, the Report includes, among others, recommendations focused on small and medium-sized enterprises that will materially improve the Bankruptcy Code for stakeholders in this broad market.

The Commission adopted a holistic and inclusive approach to its study and was guided by its mission statement, which reads:

> In light of the expansion of the use of secured credit, the growth of distressed-debt markets and other externalities that have affected the effectiveness of the current Bankruptcy Code, the Commission will study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors — with the attendant preservation and expansion of jobs — and the maximization and realization of asset values for all creditors and stakeholders.

In furtherance of its mission statement, the Commission undertook an in-depth three-year study process. The study focused exclusively on the resolution of financially distressed businesses under chapter 11 of the Bankruptcy Code.[2] This Report explains the components of the Commission's study process, summarizes the results of the study, and presents the Commission's resulting recommendations for reform in a series of principles organized generally by issue and sequence in the chapter 11 process.

Although the Commission designed its three-year process around concepts of inclusiveness, diversity of thought, leadership, and transparency, the Commission, working with the Commission's Reporter, Professor Michelle M. Harner, University of Maryland Francis King Carey School of Law, maintained exclusive control over the substance of the final Report. All decisions and recommendations set forth in the Report were made solely by the Commissioners in accordance with the voting procedures described herein. The Reporter worked closely with the Commissioners to draft the language of the recommended principles and the supporting narrative for each of those principles. Although the Reporter acted as the principal draftsperson of the Report, the Commissioners reviewed and commented on various iterations of this Report to achieve this final product. The Commission voted unanimously to adopt this Report on December 1, 2014. During the three-year study and the drafting process, the Commission was assisted in its research by Leah Barteld Clague, Jennifer Ivey-Crickenberger, and Sabina Jacobs, as well as each of the Commission's advisory committees and their respective reporters. The Commission appreciates the assistance

[2] The Commission did not address issues unique to the resolution of an individual debtor's financial distress under chapter 11. For a general discussion of these issues, *see* Section IX.C, *Individual Chapter 11 Cases*.

of all of these individuals, and acknowledges the substantial value added to this Report by the work of the advisory committees and the international working group.[3]

I. EXECUTIVE SUMMARY OF PROPOSED PRINCIPLES

Chapter 11 works to rehabilitate companies, preserve jobs, and provide value to creditors only if distressed companies and their stakeholders actually use the chapter 11 process to facilitate an in-court or out-of-court resolution of the company's financial distress.[4] Chapter 11 in turn needs to offer tools to resolve a debtor's financial distress in a cost-effective and efficient manner. To that end, the recommended principles seek to, among other things:

- Reduce barriers to entry by providing debtors more flexibility in arranging debtor in possession financing, clarifying lenders' rights in the chapter 11 case, disclosing additional information about the debtor to stakeholders, and providing a true breathing spell at the beginning of the case during which the debtor and its stakeholders can assess the situation and the restructuring alternatives;
- Facilitate more timely and efficient diligence, investigation, and resolution of disputed matters through an estate neutral — i.e., an individual that may be appointed depending on the particular needs of the debtor or its stakeholders to assist with certain aspects of the chapter 11 case, as specified in the appointment order;
- Enhance the debtor's restructuring options by eliminating the need for an accepting impaired class of claims to cram down a chapter 11 plan and by formalizing a process to permit the sale of all or substantially all of the debtor's assets outside the plan process, while strengthening the protection of creditors' rights in such situations;
- Incorporate checks and balances on the rights and remedies of the debtor and of creditors, including through valuation concepts that potentially enhance a debtor's liquidity during the case, permit secured creditors to realize the reorganization value of their collateral at the end of the case, and provide value allocation to junior creditors when supported by the reorganization value; and
- Create an alternative restructuring scheme for small and medium-sized enterprises that would enable such enterprises to utilize chapter 11 and would enable the court to more efficiently oversee the enterprise through a bankruptcy process that incentivizes all parties, including enterprise founders and other equity security holders, to work collectively toward a successful restructuring.

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[3] Additional information regarding the Commission's research assistants and the empiricists who assisted with research underlying the report are identified at ***Appendix B***. Members of the advisory committees are listed at ***Appendix C***, and members of the international working group are listed below, *infra* note 53. In addition, this Report also benefited from datasets made available to the Commission by New Generations, UCLA-LoPucki Bankruptcy Research Databases, and the Loan Syndications and Trading Association.

[4] The utility of the chapter 11 process is important not only for companies that file chapter 11 cases, but also for companies trying to achieve an out-of-court resolution. Distressed companies and their stakeholders frequently consider the federal bankruptcy alternative in deciding whether to pursue or ultimately agree to an out-of-court restructuring plan.

The Report organizes the recommended principles based on the key stages of a chapter 11 case: Commencing the Case; Administering the Case; and Exiting the Case. In addition, the Report proposes a set of principles for Small and Medium-Sized Enterprises. Finally, the Report includes a section on issues related to chapter 11 cases, but not directly tied to the Commission's mission statement or addressed by this Report. This final section discusses, among other things, issues relating to venue and jurisdiction in chapter 11 cases.

II. BACKGROUND ON THE COMMISSION AND THE STUDY PROJECT

Congress historically has turned to U.S. bankruptcy laws to help stabilize the economy in times of crisis and, beginning in 1867, to provide both individuals and corporations a single forum to address multiple creditor claims.[5] Although the law has evolved significantly since the late 1800s, the law remains focused on strengthening the economy and society more generally and, in the process, instilling confidence in businesses and markets. These objectives require a delicate balance that encourages appropriate growth and innovation in business, but provides sufficient protection and certainty to creditors.[6] Chapter 11 of title 11 of the U.S. Code (the "Bankruptcy Code") can achieve this balance for U.S. companies and markets. This section reviews the historical development of the Bankruptcy Code, explains why it is important and necessary to consider reforms to the Bankruptcy Code at this point in time, and details the Commission's study process that generated this Report and Recommendations.

A. Brief History of U.S. Business Reorganization Laws

The United States has one of the strongest and most well developed business reorganization schemes in the world.[7] This business reorganization scheme has a rich

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[5] *See, e.g.*, Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 Am. Bankr. Inst. L. Rev. 5, 18–23 (1995).

[6] One commentator explained:

> The current U.S. bankruptcy system grew directly out of the United States' unique capitalist system, which rewards entrepreneurialism as well as extensive consumer spending. It makes sense that a society in which dollars rule would have a forgiving personal bankruptcy system in order to keep consumer spending high, and an equally forgiving business reorganization system to encourage risk taking and economic growth. Both systems are part of a larger scheme to keep economic players alive and active in the game of capitalism. U.S. bankruptcy systems are among the country's few social programs and they address many of society's ills. Thus, they are broad and form an integral part of the social system from which they sprung.

Nathalie Martin, *The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation*, 28 B.C. INT'L & COMP. L. REV. 1, 3 (2005). *See also* Viral V. Acharya *et al.*, *Creditors Rights and Corporate Risk Taking*, 102 J. FIN. ECON. 150, 150–66 (Oct. 2011) ("In cross-country analysis, we find that stronger creditor rights induce greater propensity of firms to engage in diversifying acquisitions that are value-reducing, to acquire targets whose assets have high recovery value in default, and to lower cash-flow risk. Also, corporate leverage declines when creditor rights are stronger.").

[7] *See, e.g.*, Martin, *supra* note 6, at 4 ("[M]any countries have attempted to create a reorganization scheme for failing enterprises like Chapter 11 of the U.S. Bankruptcy Code (Chapter 11), in which existing management stays in place and manages the reorganizing company. These systems are perhaps the most common U.S. legal exports today.") (citations omitted).

history, stemming in large part from the railroad failures of the late 19th century.[8] The Bankruptcy Acts of 1867 and 1898 introduced the basic conceptual underpinnings of modern bankruptcy law, including business bankruptcy.[9] These laws, particularly the 1898 Bankruptcy Act, were grounded in a "rescue and rehabilitate" policy intended to allow the honest but unfortunate debtor, including the business debtor, to obtain a fresh start and a second chance at becoming a productive, contributing member of society.[10] As with all U.S. bankruptcy laws, the 1898 Bankruptcy Act sought to balance the need of the debtor to rehabilitate and the rights of creditors to recoveries. The basic notion that a business generally is more valuable to creditors and society as a whole if it rehabilitates rather than liquidates also emerged during this period.[11]

Bankruptcy law progressed in response to, among other things, the Great Depression of the 1930s,[12] and a more formalized process evolved that allowed distressed companies to remain in business while restructuring their obligations.[13] These developments produced Sections 77 and 77B of the Bankruptcy Act[14] and then the Bankruptcy Code's immediate predecessor, the Chandler Act,[15] which added three new

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[8] Harvey R. Miller & Shai Y. Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distress Businesses for the Twenty-First Century?*, 78 AM. BANKR. L.J. 153, 160 (2004) ("The foundation of United States reorganization law is the equity receivership, also known as the federal consent receivership, that was fashioned in the late nineteenth century to resolve the financial distress and failures that permeated the railroad industry after the Civil War.").

[9] For general discussions of the historical development of federal bankruptcy law, *See, e.g.*, David A. Skeel, Jr., Debt's Dominion 56–60 (2001) (explaining equity receivership process); Charles Jordan Tabb, *The History of the Bankruptcy Laws in the United States*, 3 Am. Bankr. Inst. L. Rev. 5, 21–23 (1995) (same). *See also* Charles Warren, Bankruptcy in United States History (1935); Donald R. Korobkin, *Rehabilitating Values: A Jurisprudence of Bankruptcy*, 91 Colum. L. Rev. 717, 747–49 (1991); Stephen J. Lubben, *A New Understanding of the Bankruptcy Clause*, 64 Case W. Res. L. Rev. 319 (2014).

[10] *See* Jason J. Kilborn, *Bankruptcy Law*, *in* Governing America: Major Decisions of Federal, State, and Local Governments from 1789 to the Present 41–49 (Paul J. Quirk & William Cunion eds., 2011) ("With the rise of private business corporations in the mid to late-1800s, the rescue- and rehabilitation-oriented bankruptcy policy was extended to the 'big business' context."). The 1898 Bankruptcy Act initially permitted "[c]ompositions in lieu of liquidations," and then subsequent amendments, described below, enlarged rehabilitation alternatives for businesses. *See* Tabb, *supra* note 9, at 26–30.

[11] *See, e.g.*, Charles J. Tabb, *The Future of Chapter 11*, 44 S.C. L. Rev. 791, 803 (1993) ("This idea that the preservation of a business as a going concern is better for everyone — creditors, stockholders, bondholders, employees, and the public generally — is not a new one. It has been around for at least a century, really ever since the Industrial Revolution reached full flower."). James Madison was a proponent of early recognition of bankruptcy laws, "[t]he power of establishing uniform laws of bankruptcy is so intimately connected with the regulation of commerce, and will prevent so many frauds where the parties or their property may lie or be removed into different states, that the expediency of it seems not likely to be drawn into question." Miller & Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distress Businesses for the Twenty-First Century?*, *supra* note 8, at 159& n.4 (quoting The Federalist No. 42, at 271 (James Madison) (Clinton Rossiter ed., 1961)).

[12] *See, e.g.*, Tabb, *supra* note 9, at 22.

[13] "One of the primary purposes of the Bankruptcy Act is to 'relieve the honest debtor from the weight of oppressive indebtedness, and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes." Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934). See also David S. Kennedy & R. Spencer Clift III, An Historical Analysis of Insolvency Laws and Their Impact on the Role, Power, and Jurisdiction of Today's United States Bankruptcy Court and Its Judicial Officers, 9 Norton J. Bankr. L. & Prac. 165, 176 (2000) ("The Chandler Act was the Congressional response to the depression and was modeled after the emergency legislation of the early 1930's. Since 1938, there has existed in America a Congressional policy favoring reorganization over liquidation, where possible.").

[14] Sections 77 and 77B of the 1898 Bankruptcy Act adopted various features of the equity receivership model of reorganization historically used for railroads and applied those features to railroads and other business entities. *See, e.g.*, Skeel, *supra* note 9, at 54, 106; Bussel, infra note 17, at 1555–56.

[15] "[The Chandler Act] was far-reaching in its scope and purpose. The Act comprised 15 chapters; the first seven

chapters for reorganizing ongoing businesses (Chapters X and XI concentrated on businesses, and Chapter XII addressed real estate organizations).[16] Each iteration of the law focused on strengthening business reorganizations and seeking an appropriate balance between the rights and obligations of the debtor and its stakeholders.

Under Chapter X of the Chandler Act, a trustee was appointed to replace the debtor's management, and the Securities and Exchange Commission had a formal oversight role in the reorganization process.[17] The large public companies subject to Chapter X did not embrace these two requirements.[18] They worked to avoid a bankruptcy filing — even when arguably necessary or prudent under the circumstances — or tried to come within the provisions of Chapter XI of the Chandler Act.[19] Chapter XI was intended for smaller, nonpublic companies and only addressed unsecured debt in the debtor's capital structure. Nevertheless, companies generally preferred this chapter because it placed the reorganization largely in the hands of the debtor and its unsecured creditors' committee and was premised on the efforts of these parties to structure a negotiated resolution to the debtor's financial distress.[20] After almost 40 years of restructuring experience under Chapter X and Chapter XI of the Chandler Act, policymakers and practitioners agreed that reform was needed.[21]

Consequently, in 1970, Congress created the Commission on the Bankruptcy Laws of the United States (the "Commission on Bankruptcy Laws") to "study, analyze, evaluate and recommend changes to the [1898] Act."[22] In 1973, the Commission on Bankruptcy Laws issued a report and a draft of proposed bankruptcy legislation.[23] The

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chapters dealt with the liquidation provisions substantially based upon the original 1898 Act while chapters eight through fifteen dealt primarily with the rehabilitation of various classes of debtors." Kennedy & Clift, *supra* note 13, at 176. For a detailed history and analysis of the Chandler Act, *see* Vincent L. Leibell, Jr., *The Chandler Act — Its Effect Upon the Law of Bankruptcy*, 9 Fordham L. Rev. 380, 385–409 (1940).

[16] *See, e.g.*, Alexander L. Paskay & Frances Pilaro Wolstenholme, *Chapter 11: A Growing Cash Cow Some Thoughts on How to Rein in the System*, 1 Am. Bankr. Inst. L. Rev. 331, 331 nn. 3 & 4 (briefly explaining Chapters X, XI, and XII).

[17] *See, e.g.*, SEC v. Am. Trailer Rentals Co., 379 U.S. 594, 603–06 (1965) (explaining development of the Chandler Act); Daniel J. Bussel, *Coalition-Building Through Bankruptcy Creditors' Committees*, 43 UCLA L. Rev. 1547, 1557–58 (1996) (explaining key elements of Chapter X).

[18] *See* Skeel, *supra* note 9, at 123–27 (explaining the general negative corporate reaction to Chapter X and noting that "[t]he independent trustee requirement discouraged the managers of large firms from filing for bankruptcy if there was any way to avoid it").

[19] *See id.* at 125–27. *See also* A. Mechele Dickerson, *Privatizing Ethics in Corporate Reorganizations*, 93 Minn. L. Rev. 875, 890 (2009) ("The harsh treatment managers received in Chapter X discouraged managers from using that Chapter and ultimately caused Chapter XI to become the dominant reorganization vehicle for even large, publicly traded companies that ostensibly should have filed under the trustee-controlled Chapter X."). See Harvey R. Miller, *Bankruptcy and Reorganization Through the Looking Glass of 50 Years (1960–2010)*, 19 Norton J. Bankr. L. & Prac. 3 Art. 1 (1993) for a brief comparison about the treatment of debtors and their management under Chapter X versus Chapter XI). For example, one source suggests that only a minor portion of business bankruptcies were in fact commenced through Chapter X (*e.g.*, 0.6 percent of total filings in 1971). David T. Stanley & Marjorie Girth, The Brookings Inst., Bankruptcy: Problems, Process, and Reform (1971).

[20] *See* Bussel, *supra* note 17, at 1557–58 (explaining key elements of Chapter XI).

[21] Elizabeth Warren, *Bankruptcy Policymaking in an Imperfect World*, 92 Mich. L. Rev. 336, 371–73 (1993) ("One of the key reasons for the adoption of the 1978 Code was the widespread perception that the old Code was unworkable.").

[22] Act of July 24, 1970 Establishing a Commission on the Bankruptcy Laws of the United States, Pub. L. No. 91-354, 84 Stat. 468 (1970). For further discussion about the Commission on Bankruptcy Laws and its composition, *see Report of the Commission on the Bankruptcy Laws of the United States*, 29 Bus. Law. 75, 75–76 (1973).

[23] Report of the Commission on the Bankruptcy Laws of the United States, H.R. Doc. No. 93-137 (1st Sess. 1973). *See also Report*, *supra* note 22; Frank R. Kennedy, *The Report of the Bankruptcy Commission: The First Five*

National Conference of Bankruptcy Judges, excluded from the Commission on Bankruptcy Laws, submitted a competing legislative proposal.[24] President Carter ultimately signed into law the 1978 Bankruptcy Code, which combined various concepts from both legislative proposals and merged Chapters X, XI, and XII of the 1898 Bankruptcy Act into a single business reorganization chapter (the current chapter 11).[25] In passing the Bankruptcy Code, Congress believed that "the purpose of a business reorganization case [under chapter 11] . . . is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders"[26] with the understanding that "reorganization, in its fundamental aspects, involves the thankless task of determining who should share the losses incurred by an unsuccessful business and how the values of the estate should be apportioned among creditors and stockholders."[27]

After its enactment, Congress amended the Bankruptcy Code on a periodic and piecemeal basis. In 1982, Congress broadened protections for the commodities and securities markets.[28] In 1984, Congress clarified the jurisdiction of the bankruptcy courts, set the term and appointment procedures of bankruptcy judges, and enacted specialized rules for the treatment of collective bargaining agreements.[29] In 1986, Congress created additional bankruptcy judgeships, expanded the U.S. Trustee pilot program to a nationwide program,[30] and codified chapter 12 for family farmers.[31] In 1988, Congress added protections for retirees and intellectual property licensees, and resolved conflicts between bankruptcy law and state laws.[32] In 1990, Congress added various provisions, such as swap protections, making certain debts nondischargeable, and establishing bankruptcy appellate panels.[33] In 1992, Congress added more provisions related to, among others, judgeships and chapter 12.[34] In 1994, Congress again added various provisions, including changes in time limits, exemptions, and criminal penalties.[35]

In 1994, Congress also created the National Bankruptcy Review Commission (the "NBRC") to foster a more systemic look at studying and reforming the Bankruptcy Code.[36] The NBRC issued its report in 1997,[37] and several of its recommendations were

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Chapters of the Proposed New Bankruptcy Act, 49 Ind. L.J. 422 (1974).

[24] *See* Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 DePaul L. Rev. 941, 943–44 (1979).

[25] *See* Tabb, *supra* note 9, at 35.

[26] Harvey R. Miller & Shai Y. Waisman, *Is Chapter 11 Bankrupt?*, 47 B.C. L. Rev. 129, 181 (2005) (quoting H.R. Rep. No. 95-595, at 220 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6179).

[27] *Id.* (quoting S. Rep. No. 95-989, at 10 (1978), *reprinted in* U.S.C.C.A.N. 5787, 5796).

[28] *See* 1 Norton Bankr. L. & Prac. 3d § 2:11.

[29] *See id.* § 2:12.

[30] The U.S. Trustee Program was piloted in certain judicial districts prior to the 1986 legislation. The 1986 legislation made the program permanent nationwide, with the exception of North Carolina and Alabama. Bankruptcy cases in Alabama and North Carolina are not under the jurisdiction of the U.S. Trustee, but rather are administrated by Bankruptcy Administrators in those jurisdictions.

[31] *See* 1 Norton Bankr. L. & Prac. 3d § 2:13.

[32] *See id.* § 2:14.

[33] *See id.* § 2:15.

[34] *See id.* § 2:16.

[35] *See id.* § 2:17.

[36] National Bankruptcy Review Comm'n Act, Pub. L. No. 103-394 §§ 601–702, 108 Stat. 4147 (codified at 11 U.S.C. § 101 (1994)). For more information about the NBRC and its composition, see http://govinfo.library.unt.edu/nbrc/index.html.

addressed to varying degrees in the amendments to the Bankruptcy Code set forth in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "BAPCPA Amendments").[38] BAPCPA implemented an extensive overhaul of both the business and consumer provisions of the Bankruptcy Code.[39]

BAPCPA and the prior amendments affecting chapter 11 tried to address perceived deficiencies in the Bankruptcy Code, but have in some respects altered the Bankruptcy Code's original careful balance between a debtor's need to rehabilitate and its creditors' rights to recoveries on their claims against the debtor. In addition, the amendments have introduced perceived inequities among different creditor constituencies. These factors, combined with the changing economic environment and other externalities discussed below, have diluted the effectiveness of chapter 11 for many companies and their stakeholders. Reminiscent of the time preceding the work of the Commission on Bankruptcy Laws, companies once again are working to find alternatives to filing bankruptcy cases, potentially at the expense of their creditors, shareholders, and employees.[40] Accordingly, after more than 35 years of experience under chapter 11, many practitioners and commentators agree that it is again time for reform.[41]

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[37] National Bankruptcy Review Commission Final Report: Bankruptcy: The Next Twenty Years, Oct. 20, 1997, *available at* http://govinfo.library.unt.edu/nbrc/reporttitlepg.html [hereinafter NBRC Report].

[38] *See* Susan Jensen, *A Legislative History of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005*, 79 AM. BANKR. L.J. 485, 487–88 (2005).

[39] Lubben, *supra* note 9, at 407–08.

[40] A restructuring law that companies seek to avoid at all costs can exasperate companies' financial distress and negatively impact the overall economy. It can cause companies to increase leverage beyond sustainable levels in the hopes of buying time to find out-of-court solutions. It can encourage companies to engage in speculative projects, undertake precipitous reductions in workforce, and delay payments to vendors and suppliers who in turn may experience financial difficulties. This was the state of U.S. business bankruptcy laws in 1978 when Congress enacted the Bankruptcy Code to overhaul Chapters X and XI of the 1898 Bankruptcy Act. It is again the state of U.S. business bankruptcy laws, with companies — particularly small and medium-sized enterprises — avoiding a chapter 11 filing whenever possible because of inefficiencies, uncertainty, and costs associated with the chapter 11 process. *See, e.g.*, *infra* note 60; *Exploring Chapter 11 Reform: Corporate And Financial Institution Insolvencies; Treatment of Derivatives: Hearing Before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of the H. Comm. on the Judiciary*, 113th Cong. (Mar. 26, 2014) (written testimony of Professor Michelle M. Harner, Co-Director, Business Law Program, University of Maryland Francis King Carey School of Law), at 2 & nn. 7–9 (noting that chapter 11 has become too expensive for businesses and causes companies to close rather than timely file for bankruptcy, which has adverse consequences for the companies, their employees, and the economy) (citations omitted), *available at* http://judiciary.house.gov/index.cfm/2014/3/hearing-exploring-chapter-11-reform-corporate-and-financial-institution-insolvencies-treatment-of-derivatives.

[41] *See* Richard Levin & Kenneth Klee, *Rethinking Chapter 11*, Int'l Insolvency Inst., Twelfth Annual Int'l Insolvency Conf. (June 21–22, 2012), *available at* http://www.iiiglobal.org/component/jdownloads/finish/337/5966.html. *See also* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 Stan. L. Rev. 673 (2003); Stephen J. Lubben, *Some Realism About Reorganization: Explaining the Failure of Chapter 11 Theory*, 106 Dick. L. Rev. 267 (2001); Harvey R. Miller, *Chapter 11 in Transition — From Boom to Bust and into the Future*, 81 AM. BANKR. L.J. 375 (2007); Miller & Waisman, *Does Chapter 11 Reorganization Remain a Viable Option for Distressed Businesses for the Twenty-First Century?*, *supra* note 8; Miller & Waisman, *Is Chapter 11 Bankrupt?*, *supra* note 26; James H. M. Sprayregen et al., *Chapter 11: Not Perfect, but Better than the Alternative*, Am. Bankr. Inst. J., Oct. 2005, at 1; *Written Statement of Bettina M. Whyte: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2012) (providing an intriguing narrative story of how times have changed and the Bankruptcy Code has not), *available at* Commission website, *infra* note 55.

B. The Need for Reform

Chapter 11 of the Bankruptcy Code has served us well for many years. Nevertheless, today'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;[42] 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.[43]

Moreover, anecdotal evidence suggests that chapter 11 has become too expensive (particularly for small and medium-sized enterprises) and is no longer capable of achieving certain policy objectives such as stimulating economic growth, preserving jobs and tax bases at both the state and federal level, or helping to rehabilitate viable companies that cannot afford a chapter 11 reorganization.[44] Some professionals suggest that more companies are liquidating or simply closing their doors without trying to

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[42] *See, e.g.*, Mark Jenkins & David C. Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization*, (paper presented at April 2014 symposium) (draft on file with Commission) ("Secured debt represented less than 45 percent of the debt of Moody's- rated firms filing for bankruptcy in 1991; by 2012, secured debt accounted for more than 70 percent of the debt of Moody's- rated bankruptcy filers."), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2444700. For a discussion of the amendments to the Uniform Commercial Code and their potential impact on secured creditors' collateral packages, *see* Section VI.C.4, *Section 552(b) and Equities of the Case*.

[43] *See, e.g.*, Ralph Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News *(Part II): Limiting Credit Bidding*, Bankr. L. Letter, July 2014, at 4 ("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.") (citations omitted).

[44] *See, e.g., Oral Testimony of Joseph McNamara: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (May 21, 2013) ("In my experience, over the last half decade, companies have had a harder and harder time successfully reorganizing their debt and using the chapter 11 process, and thus are more prone to either fold their reorganization procedure into a liquidation or successfully exit and then re-enter bankruptcy a few short years later."), *available at* Commission website, *infra* note 55. *See also* Stephen J. Lubben, *What We "Know" About Chapter 11 Cost is Wrong*, 17 Fordham J. Corp. & Fin. L. 1 (2012) (reviewing literature and presenting empirical data to contradict common perceptions of bankruptcy costs); *Written Statement of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2013) (describing an increase in the use of nonbankruptcy alternatives, including increased unsupervised winddowns, as a result of the costs and loss of control associated with chapter 11), *available at* Commission website, *infra* note 55; *Oral Testimony of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 36 (Apr. 19, 2013) (ASM Transcript) (describing how the DIP budget for professionals' fees has ballooned and noting that such costs keep small businesses out of chapter 11), *available at* Commission website, *infra* note 55.

rehabilitate under the federal bankruptcy laws.[45] Commentators and professionals also suggest that companies are waiting too long to invoke the federal bankruptcy laws, which limits companies' restructuring alternatives and may lead to premature sales or liquidations.[46]

Not all commentators agree that significant reform to chapter 11 is necessary. Some suggest that any changes could have unintended consequences or negatively impact credit markets. Others simply suggest that the system continues to work well enough.[47] These issues are at the heart of the Commission's study. As explained below, the Commission's process was designed to explore the new environment in which financially distressed companies operate and to determine what aspects of the current system are — and are not — working as well as possible.

C. The Commission's Study

The Commission has undertaken a methodical study of chapter 11 of the Bankruptcy Code. Over 250 corporate insolvency professionals (including the Commissioners, committee members, and hearing witnesses) participated in this study. The Commission has strived to include all perspectives, ideologies, and geographic and industry segments.

Notably, the Commission's process resembles that of the 1970 Commission on Bankruptcy Laws and, more recently, the 1994 NBRC in several respects. For example, the Commission used an advisory committee structure, described below, similar to the eight-topic committee structure invoked by the NBRC.[48] Similar to the NBRC, the Commissioners retained authority for addressing and deciding each issue.[49] Moreover, each of the field hearings hosted by the Commission and described below was open to the public, and the transcripts (and, in many cases, video recordings) are posted on the Commission's website at www.commission.abi.org (the "Commission website"). In addition, similar to the process followed by the NBRC, the Commissioners appeared at restructuring events throughout the country to discuss and publicize the Commission's work and to solicit feedback from affected constituents.[50]

The Commission has met on a regular basis since January 2012. During these meetings, the Commission has, among other things, discussed issues perceived as potential problems in chapter 11, reviewed recent developments in the case law and practice norms, and developed an effective process for identifying, researching, and

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[45] *See, e.g.*, Douglas G. Baird & Robert K. Rasmussen, *The End of Bankruptcy*, 55 Stan. L. Rev. 751, 777–85 (2002) (discussing decrease in traditional stand-alone reorganizations). *See also Oral Testimony of Dan Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 37 (Apr. 19, 2013) (ASM Transcript) (describing increased use of state and local receiverships and ABCs in lieu of chapter 11 or chapter 7 because of the reduced costs and reduced delay), *available at* Commission website, *infra* note 55.

[46] *See, e.g.*, Michelle M. Harner & Jamie Marincic Griffin, *Facilitating Successful Failures*, 66 Fla. L. Rev. 205 (2014) (analyzing literature and presenting results of empirical survey on, among other things, timing of bankruptcy filings). *See generally infra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[47] *See, e.g.*, Stuart C. Gilson, *Coming Through a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. Applied Corp. Fin. 23 (2012).

[48] *See* NBRC Report, *supra* note 37, at 60–61.

[49] *See id.* at 61.

[50] *See id.* at 63.

analyzing chapter 11 as a whole. As explained below, the Commission used its advisory committees and numerous public field hearings to amass the information and research it required to critically analyze chapter 11 and consider any reform measures.

The Advisory Committees. To launch its study, the Commission identified 13 broad study topics to facilitate a detailed analysis of the various components of chapter 11. These study topics are: (1) administrative claims and other pressures on liquidity; (2) avoiding powers (e.g., preferences and fraudulent conveyances); (3) bankruptcy-remote and bankruptcy-proof entities; (4) distributional issues under plans; (5) executory contracts and unexpired leases; (6) financial contracts, derivatives, and safe harbors; (7) financing issues; (8) governance and supervision of cases; (9) labor and benefits issues; (10) multiple entities and corporate groups; (11) procedural and structural issues under plans; (12) role of valuation; and (13) asset sales in chapter 11.[51] The Commission then enlisted the volunteer service of more than 150 of the insolvency profession's expert judges, lawyers, financial advisors, academics, and consultants to serve on advisory committees for each of these study topics.[52]

In forming the advisory committees, the Commission carefully vetted individuals who were qualified to address particular issues within any given advisory committee's charge. This vetting process considered not only the individual's knowledge and expertise in the area, but also whether the individual would be likely to add a particular perspective on the issues while still considering the overall integrity of the bankruptcy system. As such, each advisory committee received input from the perspective of the various chapter 11 constituents — e.g., lenders, trade creditors, landlords, employees, etc. — on each of the issues they addressed and presented to the Commission. The diverse perspectives of the Commissioners and of the advisory committees added substantial value to the Commission's deliberations and decisions and the proposals encompassed in this Report.

The advisory committees began their work in April 2012. The Commission provided each advisory committee with a preliminary assessment containing initial study questions for its general topic area. Each advisory committee devoted significant time to researching and evaluating the study questions. The advisory committees met either in-person or telephonically on a frequent basis to review their research and debate the issues. The advisory committees engaged in this work for approximately 18 months before submitting research reports on most topics to the Commission in December 2013.

The Commission then held a three-day retreat in February 2014 to meet with each advisory committee and discuss the research reports. At the retreat, the advisory committees presented their reports and highlighted complex and nuanced issues for the Commission, and the Commissioners actively engaged in a direct dialogue with

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[51] The Commission deferred the work of the advisory committee on multiple entities and corporate groups; in the end, many of the study questions initially assigned to that committee overlapped with and were addressed by other committees or the Commission as a whole.

[52] As noted above, *supra* note 3, the names and affiliations of members of the advisory committees are listed at Appendix C. In addition, several of the advisory committees identified, and the Commission appointed, research fellows to provide research and other support for the work of those advisory committees. The Commission is grateful for the service and contributions of the advisory committee research fellows.

advisory committee members. The Commission also used the forum to begin integrating the study topics and reconciling overlapping issues. The retreat and the work of the advisory committees leading up to the retreat sessions were informative and very helpful to the Commission in this process. Since then, the Commission has reviewed the entire body of work produced by the advisory committees and conducted follow-up research and analysis on a variety of issues.

The Commission also formed an international working group consisting of leading practitioners and academics from 13 different countries.[53] The working group has studied targeted questions posed by the Commission and the advisory committees to provide a comparative analysis of the relevant issues. These questions generally involved the following broader topics: (i) the use of surcharges in sales; (ii) the treatment of intellectual property licenses in insolvency; (iii) financing options for insolvent companies; (iv) the role of administrators and monitors; (v) plan issues (presenting, voting, plans variations, and allocation rules); (vi) creditors' or stakeholders' committees; and (vii) claims trading.

The Field Hearings. The Commission held its first public hearing in April 2012 at the U.S. House of Representatives Committee on the Judiciary in the Rayburn House Office Building in Washington, D.C. Since that time, the Commission has held 16 public field hearings in 11 different cities: Boston, Las Vegas, Chicago, New York, Phoenix, San Diego, Tucson, Philadelphia, Austin, Atlanta, and Washington, D.C. Collectively, almost 90 individuals testified at these hearings.[54] The testimony at each of these hearings was substantively rich and diverse. The hearings covered a variety of topics, including chapter 11 financing, general administrative and plan issues, governance, labor and benefits issues, priorities, sales, safe harbors, small and medium-sized enterprise cases, valuation, professionals' fees, executory contracts (including commercial leases and intellectual property licenses), trade creditor issues, and reform of avoiding powers. Transcripts and videos of the hearings, and the related witness statements, are available at the Commission website.[55] A summary of the hearing topics is attached at Appendix E.

Several common themes emerged from the field hearings. First, many witnesses acknowledged that chapter 11 cases have changed over time.[56] These changes include:

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[53] Members of the international working group are: Dr. A. Klauser and L. Weber, from Austria; S. Atkins and Professor R. Mason, from Australia; Professor M. Vanmeenen and N. Wouters, from Belgium; S. Golick, from Canada; J-L. Vallens, M. André and R. Dammann, from France; Professor R. Bork, Professor S. Madaus and A. Tashiro, from Germany; Professor S. Bariatti and G. Corno, from Italy; H. Sakai, from Japan; Professor P.M. Veder and R.J. van Galen, from the Netherlands; Professor Wang Weigo and Professor Li Shuguang, from the People's Republic of China; Professor F. Garcimartín and A. Núñez-Lagos, from Spain; Professor A. Boraine and A. Harris, from South Africa; Professor I.F. Fletcher, I. Williams, S. Bewick and R. Heis, from England and Wales; and G. Stewart and M. Robinson from INSOL International, and Professor B. Wessels and R.J. de Weijs, from the Netherlands as organizing members. Further contributions were made by E. Dellit, L. Farley, T. Hamilton, L. McCarthy and D. Elliott (Australia), C. Fell, M. Rochkin, S. Obal and Professor J. Sarra (Canada), L. Valentovish (Japan), L. Harms (South Africa) and C. E. Poolis (England).

[54] The names and affiliations of these witnesses are listed at ***Appendix D***.

[55] All testimony and statements related to the Commission's study from 2012 through 2014 that are cited in the Report are available at the Commission website at www.commission.abi.org [hereinafter Commission website].

[56] *See Oral Testimony of Bryan Marsal: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 15–19 (Oct. 26, 2012) (NCBJ Transcript) ("There is a gradual erosion of the underlying public principle of the Code which was to preserve jobs and maximize value through rehabilitation."), *available at* Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the*

(1) a perceived increase in the number and speed of asset sales under section 363 of the Bankruptcy Code;[57] (2) a perceived decrease in stand-alone reorganizations; (3) a perceived decrease in recoveries to unsecured creditors;[58] and (4) a perceived increase in the costs associated with chapter 11.[59] Second, the witnesses who testified on issues relating to small and medium-sized enterprises generally opined that chapter 11 no longer works for these companies. Witnesses cited cost and procedural obstacles as common barriers.[60] Third, the witnesses who testified on financial contracts and derivatives generally agreed that the safe harbor protections have been extended to contracts and situations beyond the original intent of the legislation.[61] They did not necessarily agree, however, on appropriate limitations or revisions to the relevant

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Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting, at 2 (Nov. 15, 2012) ("[A] principal criterion for evaluating any proposed amendments to the Code is the extent to which they maximize the value of companies as going concerns (thereby preserving jobs and maximizing value for creditors) either through a reorganization in those situations where reorganization is a realistic option, or through a sale or liquidation where reorganization is not a realistic option."), *available at* Commission website, *supra* note 55.

[57] *See Oral Testimony of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 19 (Nov. 3, 2012) (TMA Transcript) ("When sales occur too quickly before the rehabilitative process, the yield to prepetition creditors is diminished."), *available at* Commission website, *supra* note 55; *Oral Testimony of Michael Richman: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 20 (Oct. 26, 2012) (NCBJ Transcript) (recommending that section 363 sales should be modified so that courts can restrain hasty sales and better monitor expedited sales), *available at* Commission website, *supra* note 55.

[58] *See Written Statement of Paul Calahan: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (May 21, 2013) ("The Code and the economic environment have made it more difficult for unsecured creditors to realize fair payment of their claims . . . A voice for unsecured creditors is clearly needed and provides valuable insight to the court and other parties."), *available at* Commission website, *supra* note 55; *Written Statement of Joseph McNamara: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (May 21, 2013) ("A tremendous disparity remains between payment of secured and unsecured claims and some evidence suggests secured creditors with first liens experienced outstanding recoveries, while unsecured recoveries were around 20%, with the median recovery set at 10%."), *available at* Commission website, *supra* note 55.

[59] *See Written Statement of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2013) (recommending that the level of professionals should be rationalized at the onset of a case and fees and billing should be more transparent and have greater oversight during the process to keep overall costs down), *available at* Commission website, *supra* note 55.

[60] *See Written Statement of the Honorable Dennis Dow: Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2013) (noting that the complexity, time, and costs of the chapter 11 process impose obstacles that small business debtors often cannot overcome), *available at* Commission website, *supra* note 55; *Written Statement of Professor Anne Lawton: NCBJ13 Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 1, 2013) ("The Code's small business debtor definition should be simplified."), *available at* Commission website, *supra* note 55; *Oral Testimony of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 7, 15 (Nov. 3, 2012) (TMA Transcript) ("A one-size-fits-all approach for the Code does not work because smaller businesses have special needs."), *available at* Commission website, *supra* note 55; *Oral Testimony of Jeff Wurst: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 28 (June 4, 2013) (NYIC Transcript) (stating smaller companies can no longer afford to seek protection under chapter 11), *available at* Commission website, *supra* note 55.

[61] *See Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (asserting that the breadth of safe harbors has had unintended consequences and some courts have held that safe harbors extend to protect one-off private transactions that do not affect financial institutions), *available at* Commission website, *supra* note 55; *Oral Testimony of Jane Vris on behalf of the National Bankruptcy Conference: NYCBC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 9 (May 15, 2013) (NYCBC Transcript) ("The original purpose of the safe harbors was to preserve the clearing of payments and delivery within a fair closed system, the protections have now expanded beyond that."), *available at* Commission website, *supra* note 55; *Written Statement of Jane Vris on behalf of the National Bankruptcy Conference: NYCBC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (May 15, 2013), *available at* Commission website, *supra* note 55.

sections of the Bankruptcy Code.[62] Finally, witnesses — even those who were highly critical of certain aspects of chapter 11 — all perceived value in the U.S. approach to corporate bankruptcies, including the debtor in possession model.[63]

In addition, the Commission worked with the University of Illinois College of Law to organize and host an academic symposium on the role of secured credit in business bankruptcies in April 2014. Nineteen of the nation's leading bankruptcy scholars contributed to the symposium.[64] The symposium was open to the public, and both the scholarship presented and a video recording of the event are posted on the Commission website. Many of the scholarly papers from this symposium will also be published in a forthcoming issue in the 2015 volume of the Illinois Law Review.

D. The Commission's Deliberations

Immediately following its February 2014 retreat, the Commission began its in-depth review of the advisory committees' reports and recommendations, various issue-specific white papers prepared by the Commission's Reporter with the assistance of the Commissioners and research fellows, the papers from the Illinois symposium, and testimony and papers submitted by hearing witnesses and restructuring professionals.[65] The Commission then held five separate executive session retreats to deliberate, formulate, and vote on the content of this Report. Two of these retreats were held in Virginia, two in New York, and one in Chicago. The Commission also held numerous subcommittee meetings in between each of these executive session retreats.

At each of the executive sessions, the Commission reviewed issues raised by witness testimony or examined in the research materials prepared by the Reporter and the advisory committees, including the advisory committee's recommendations on the initial study topics posed by the Commission. Moreover, the reports of the international working group informed many of the Commission's deliberations. From these discussions, the Commissioners worked to identify areas of potential reform that would, among other things, improve case efficiencies, enhance business rehabilitations and creditors' recoveries, and resolve uncertainty or ambiguity in the current law.

During the three-year study process, and in connection with its deliberations, the Commission compiled and reviewed, among other materials, an extensive database of empirically based articles and working papers concerning different aspects of chapter

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[62] *See Oral Testimony of the Honorable James Peck: NYCBC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 31–32 (May 15, 2013) (NYCBC Transcript) (recommending that judges should have more discretion to determine whether contracts fit the criteria for protection under the safe harbors), *available at* Commission website, *supra* note 55.

[63] *See Written Statement of William Greendyke: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 22, 2013) (reporting that the membership of the Bankruptcy Law Section of the State Bar of Texas noted that the chapter 11 process still worked, but found it to be more expensive and "faster" than 10 years ago), *available at* Commission website, *supra* note 55.

[64] The names and affiliations of the academics who presented at this symposium are listed at ***Appendix F***.

[65] Certain of the materials that the Commission reviewed and discussed during the three-year study and deliberative process are identified in the footnotes in this Report. These citations capture but a fraction of the materials collected and reviewed by the Commissioners during this process. It simply was not feasible to cite all relevant sources and materials. The absence of a citation to a particular court opinion, empirical study, law review article, or witness's testimony does not mean that such material was not considered and analyzed by the Commissioners.

11 of the Bankruptcy Code. In reviewing all empirical data, including the data cited in this Report, the Commissioners were aware of the limitations that frequently impact chapter 11 data, including the following. First, endogeneity bias often is a problem in chapter 11 studies: (i) to the extent that omitted or unattainable information affects results (e.g., off-docket activity and negotiations; makeup of creditor body; talent or dynamics of management team; financial condition of debtor prior to and on petition date; impact of pre-petition management decisions on company's case; and, in some instances, economic or industry cycles), omitted variable bias occurs; and (ii) when the causal direction between two variables cannot be determined, simultaneity bias might occur (e.g., does the presence of private funds in a case make it more successful or do private funds invest in cases that are better positioned to be more successful).[66] Second, selection bias can occur when subsets of available data sources are not randomly sampled or the pool from which the sample is drawn is not representative of the entire population (self-selection bias can also limit empirical survey studies). Third, coder bias and intercoder reliability can skew interpretation or results (e.g., if more than one coder is involved in the project, each may interpret the often subjective items on a chapter 11 docket in different ways, despite efforts to achieve an acceptable intercoder reliability rate). Fourth, data are limited and subjective: for example, it is difficult to define "success" in chapter 11; it is difficult to determine if a plan is a traditional stand-alone reorganization or a merger or a third party sale — they are all change of control events, and many datasets do not capture these nuances; and outside of public bondholders, it is difficult to determine recoveries in chapter 11 cases, particularly for smaller cases. Finally, because of the biases and limitations noted above, as well as others not discussed here, it might be difficult to establish strong claims of causality in empirical studies of chapter 11 cases. Nevertheless, the Commission reviewed empirical data from numerous sources and supporting a variety of different positions on the issues before it; it found all of the data informative, and it used the data in its overall consideration of all relevant factors.

The recommended principles set forth in this Report are the result of the Commission's study and deliberative process. The Commissioners voted on each principle, and a principle was adopted as a Commission recommendation if it received support from two-thirds of the Commissioners voting, with 11 favorable votes being the minimum required for a principle being reported as a recommendation. If the requisite level of support was not obtained, this Report includes a description of the issue, a summary of the factors considered by the Commission in connection with the issue, and a notation that no consensus emerged. The Commission believed that this Report achieves its core mission to "study and propose reforms to Chapter 11 and related statutory provisions that will better balance the goals of effectuating the effective reorganization of business debtors — with the attendant preservation and expansion of jobs — and the maximization and realization of asset values for all creditors and stakeholders."[67]

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[66] *See generally* Michael R. Roberts & Toni M. Whited, *Endogeneity in Empirical Corporate Finance*, *in* Handbook of the Economics of Finance (2014) (discussing these issues with endogeniety, as well as measurement errors in that context).

[67] *See* Commission's mission statement, *supra* at 3.

III. PROPOSED RECOMMENDATIONS: COMMENCING THE CASE

The financially distressed company is typically the party that commences the chapter 11 case by filing a voluntary petition for relief under chapter 11 of the Bankruptcy Code. Although creditors may file an involuntary chapter 11 petition against a company under section 303 of the Bankruptcy Code, creditors rarely invoke this remedy.[68] One study reported that involuntary bankruptcies "have represented less than one-tenth of one per cent of all U.S. liquidation bankruptcy cases for over a decade."[69] Creditors may consider an involuntary chapter 11 filing during their pre-petition negotiations with a debtor. It is most common, however, for the debtor to then file a voluntary case or for the parties to reach an out-of-court resolution.[70]

Companies do not undertake a chapter 11 filing lightly. A company's management is commonly concerned about the public nature of a chapter 11 case and the potential distractions to the business caused by enhanced oversight from the court, the U.S. Trustee, creditors, and other parties in interest.[71] In fact, some commentators and practitioners suggest that financially distressed companies tend to wait too long to file a chapter 11 case, which makes it more difficult to use the restructuring tools of chapter 11 in an effective manner.[72] Regardless, chapter 11 provisions should help companies achieve a "soft landing" in bankruptcy — i.e., minimize business disruptions to foster reorganization prospects — and develop a feasible restructuring strategy that benefits all stakeholders.

Witnesses before the Commission testified concerning the various perceived barriers to successful reorganizations under chapter 11, including challenges to financing chapter 11 cases, uncertainty and costs associated with the bankruptcy process, delays built into the process, and insufficient value available to support a restructuring.[73] Some witnesses suggested that these perceived barriers may cause

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[68] The Administrative Office of the U.S. Courts stopped collecting data on involuntary bankruptcies apparently because of their rarity. *See* Robert M. Lawless & Elizabeth Warren, *The Myth of Disappearing Business Bankruptcy*, 93 Cal. L. Rev. 743, 750 n.11 (2005).

[69] Jason Kilborn & Adrian Walters, *Involuntary Bankruptcy as Debt Collection: Multi-Jurisdictional Lessons in Choosing the Right Tool for the Job*, 87 Am. Bankr. L.J. 123, 125 (2013).

[70] *See* Susan Block-Lieb, *Why Creditors File So Few Involuntary Petitions and Why the Number Is Not Too Small*, 57 Brooklyn L. Rev. 803, 805–06 ("Creditors file few involuntary petitions because they often prefer a negotiated resolution of a debtor's financial troubles.").

[71] *See, e.g.*, Stephen J. Lubben, *The Direct Costs of Corporate Reorganization: An Empirical Examination of Professional Fees in Large Chapter 11 Cases*,74 AM. BANKR. L.J. 509, 543 ("The indirect costs [of chapter 11] . . . include loss in value due to managerial distraction, foregone investment opportunities, erosion of customer confidence, increases in employee turnover, and increased cost of supplier credit.").

[72] *See, e.g.*, Harner & Griffin, *supra* note 46, 324–38 (2014) (presenting empirical survey of 453 restructuring professionals and data showing that, of those professionals who had clients refuse to file a bankruptcy case at a time the professional thought advisable, 90 percent of those companies ultimately had to file a case). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[73] *See Oral Testimony of Josh Gotbaum: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 18 (Mar. 14, 2013) (ACB Transcript) ("[I]n many cases financial institutions and financial markets have outstripped the law's ability to comprehend them and the bankruptcy court's ability to preserve fair treatment of other constituencies in the face of them."), *available at* Commission website, *supra* note 55; *Oral Testimony of Wilbur Ross: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–7 (Apr. 19, 2013) (ASM Transcript) (discussing unpredictable cost increases in chapter 11), *available at* Commission website, *supra* note 55; *Oral Testimony of the Honorable James Peck: VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 29–30 (Feb. 21, 2013) (VALCON Transcript) (discussing problems faced in

companies to forego the chapter 11 process entirely.[74] Anecdotal evidence likewise indicates that distressed companies are increasingly turning to state law remedies (e.g., receiverships and assignments for the benefit of creditors) and equity receivership law with more frequency now than in the past 75 years.[75] Moreover, there is no meaningful way to discern how many distressed companies that could have used chapter 11 simply closed their doors instead of pursuing alternatives through the reorganization process.

The Commission was very mindful of these considerations in reviewing issues relating to the filing, financing, and initial steps of a chapter 11 case. The principles in this section strive to address several of these issues.

A. Oversight of the Case

1. The Debtor in Possession Model

Recommended Principles:

- The ability of the debtor to act as a debtor in possession and assume the duties and powers of a trustee in bankruptcy is a central feature of chapter 11 of the Bankruptcy Code. It allows the debtor to continue its operations with minimal disruptions while still serving the interests of the debtor's creditors and, in many cases, its equity security holders as well. Accordingly, the debtor in possession model should continue as the default rule under chapter 11.
- Applicable state law fiduciary duties should continue to govern the conduct of the debtor in possession's board of directors, officers, or similar managing persons.
- For a discussion of directors', officers', and similar managing persons' fiduciary duties in the plan context, see Section VI.A.2, *Role of Debtor in Plan Process*.

a. The Debtor in Possession: Background

A fundamental feature of chapter 11 of the Bankruptcy Code is the "debtor in possession" concept. This feature allows the financially distressed company to remain

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some cases, including waste and delay as a result of valuation issues), *available at* Commission website, *supra* note 55.

[74] *See Written Statement of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2013) (stating that a large majority of clients avoid chapter 11 and seek state law relief because of the costs, delay, structure of case administration, control by the secured creditor, and lack of flexibility attendant in a chapter 11 case), *available at* Commission website, *supra* note 55; *Oral Testimony of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 34–36 (Apr. 19, 2013) (ASM Transcript) (same), *available at* Commission website, *supra* note 55.

[75] *Oral Testimony of Dan Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 36–39 (Apr. 19, 2013) (ASM Transcript) (discussing increased use of state law alternatives to chapter 11 such as local and state receiverships and assignments for the benefit of creditors (ABCs)), *available at* Commission website, *supra* note 55. For a further discussion of the use of receiverships, *see* Section VII.B, *General Application of SME Principles*.

in control of its assets and to continue to operate its business after commencing the chapter 11 case. Accordingly, on the petition date, the company assumes the new legal capacity of a "debtor in possession."[76]

In a typical chapter 11 case, the debtor in possession's pre-petition board of directors and officers will continue to manage the debtor's affairs and make decisions regarding both the debtor's business and its reorganization efforts in the chapter 11 case. The debtor in possession model was expanded by chapter 11 in the 1978 Bankruptcy Code from the company's active role in the rehabilitation process under Chapter XI (but not Chapter X) of the 1898 Bankruptcy Act.[77] Practice under the Bankruptcy Act suggested that boards of directors and management resisted a process — even if arguably beneficial to their restructuring efforts — that required them to cede control of their business and restructuring efforts to an outside party. This requirement contributed in part to the failure of Chapter X of the Bankruptcy Act because it mandated the appointment of a trustee to run the debtor's business and bankruptcy case.[78] Notably, section 1107 of the Bankruptcy Code authorizes the debtor in possession to, among other things, exercise all "the rights . . . and powers, and [requires it to] perform all the functions and duties . . . of a trustee serving in a case under this chapter," with only minor exceptions that do not detract from the central role of the debtor in possession in the case.[79]

Proponents of the debtor in possession model highlight the knowledge and expertise of the debtor's pre-petition directors, officers, or similar managing persons concerning the debtor's business and financial affairs.[80] The ability of the debtor in possession to continue to operate through its pre-petition management team facilitates the company's seamless transition into chapter 11 and allows the debtor to avoid the additional time, cost, and resulting inefficiencies of bringing in an outsider who is not

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[76] This Report refers only to the trustee in certain principles, and those references are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code. In addition, the Report discusses the implications of certain principles for debtors in possession, which likewise apply to any chapter 11 trustee appointed in the case.

[77] *See* Clifford J. White III & Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners After BAPCPA*, 80 Am. Bankr. L.J. 289, 292 n. 15 (2006) ("[T]he debtor generally remained in possession of its property and had all of the rights and powers of a trustee, subject to such limitations as the court might impose.") (citations omitted). *See generally* John Wm. Butler, Jr., et al., *Preserving State Corporate Governance Law in Chapter 11: Maximizing Value Through Traditional Fiduciaries*, 18 Am. Bankr. Inst. L. Rev. 337 (2010) (detailing the history and role of the debtor in possession model in chapter 11).

[78] *See* H.R. Rep. No. 95-595, at 222, *reprinted in* 1978 U.S.C.C.A.N. 6182 ("Less than ten percent of all business reorganization cases are under Chapter X. Chapter XI is the much more popular procedure, even though what can be done under Chapter XI is less than under Chapter X.") (citation omitted). *See also* Douglas E. Deutsch, *Ensuring Proper Bankruptcy Solicitation: Evaluating Bankruptcy Law, the First Amendment, the Code of Ethics, and Securities Law in Bankruptcy Solicitation Cases*, 11 Am. Bankr. Inst. L. Rev. 213, 217–18 (2003) (explaining debtors' preference for Chapter XI under the Bankruptcy Act). The inflexible, mandatory absolute priority rule was also arguably a contributing factor to its failure. *See* Skeel, *supra* note 9, at 163 ("The draconian effect of Chapter X, together with the fact that so many large firms had already failed during the depression, caused a dramatic drop in Chapter X cases.").

[79] 11 U.S.C. § 1107.

[80] *See, e.g.*, *In re* Marvel Entm't Grp., Inc., 140 F.3d 463, 471 (3d Cir. 1998) ("[V]ery often the creditors will be benefited by continuation of the debtor in possession, both because the expense of a trustee will not be required, and the debtor, who is familiar with his business, will be better able to operate it during the reorganization case.").

familiar with the debtor's business specifically or the debtor's industry generally.[81] The pre-petition management team may also have industry relationships or "know-how" that would benefit the debtor's restructuring efforts.

Critics of the debtor in possession model note that the debtor's financial or operational difficulties may relate, at least in part, to the conduct or decisions of the debtor's pre-petition directors and officers.[82] Some critics argue that allowing the management team that was in charge during the debtor's financial decline to remain in control rewards subpar performance and undermines confidence in the reorganization process for the debtor's stakeholders.[83] Some critics also worry that pre-petition management may be motivated by factors not necessarily aligned with the best interests of the estate, such as retaining their jobs or downplaying pre-petition events that may implicate them in the debtor's financial distress.[84]

Although the criticisms of the debtor in possession model raise some valid concerns, rather than being caused by management, a company's chapter 11 filing is frequently triggered by a downturn in the overall economy, a fluctuation in markets particular to the debtor's industry (e.g., pricing of a commodity necessary to the debtor's operations), or a failed (but not negligent or fraudulent) business strategy. In these instances, the debtor's management team typically maintains the confidence of the debtor's stakeholders and can be an asset to the debtor's reorganization efforts. Moreover, in some cases, the debtor may have replaced certain (or all) of its directors or officers either well before or shortly before filing in anticipation of the chapter 11 filing. These management changes may include the appointment of a chief restructuring officer who is often an experienced restructuring professional.[85] Accordingly, the debtor's management immediately preceding the petition date may be completely divorced from the decisions, actions, and circumstances that contributed to the debtor's distress.

The Bankruptcy Code also places certain checks on the debtor in possession's power and decision-making authority in chapter 11. For example, the debtor in possession may be replaced by a trustee for cause; a statutory unsecured creditors'

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[81] *See* H.R. Rep. No. 95-595, at 233, *reprinted in* 1978 U.S.C.C.A.N. 6192 ("A trustee frequently has to take time to familiarize himself with the business before the reorganization can get under way."). *See also* David A. Skeel, Jr., *Markets, Courts, and the Brave New World of Bankruptcy Theory*, 1993 Wis. L. Rev. 465, 517 & n.188 (1993) ("In the nonclosely held firm context, immediate removal of management would create significant indirect costs both before and during the bankruptcy.").

[82] *See, e.g.*, A. Mechele Dickerson, *The Many Faces of Chapter 11: A Reply to Professor Baird*, 12 Am. Bankr. Inst. L. Rev. 109, 135 (2004) ("[T]here should be a rebuttable presumption that the directors of insolvent firms are unfit for board service and that they should be disqualified from future board service"); Lynn M. LoPucki, *The Trouble with Chapter 11*, 1993 Wis. L. Rev. 729, 732 n.11 (1993) (noting that prepetition management may pursue "directions that are not in economic interests of the company").

[83] *Written Testimony of the Honorable Joan N. Feeney: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (Apr. 19, 2012) (citing a Cornell University study indicating that the strongest contributor to post-bankruptcy success is new management and arguing that bankruptcy judges need tools to deal with failed managers), *available at* Commission website, *supra* note 55.

[84] *See* LoPucki, *supra* note 82, at 733 ("Because the[] [management] retain[s] the benefits of risk taking without suffering a corresponding share of the losses, it may be in their interests that the company take risks not justified by the expected returns to the company.").

[85] *See, e.g.*, Butler, et al., *supra* note 77, at 356 ("Employing turnaround professionals as CROs has become common in recent years. Often creditors insist that companies install third-party CROs in the midst of a dire financial situation.").

committee frequently is appointed to oversee the debtor in possession's conduct and to represent the interests of unsecured creditors; major decisions and transactions require notice, hearing, and court approval; and the U.S. Trustee and parties in interest have standing to raise and be heard on matters in the case.[86] In addition, the directors, officers, or similar managing persons of the debtor in possession are bound by their state law fiduciary duties.[87]

b. The Debtor in Possession: Recommendations and Findings

The Commission considered the arguments in favor of and against the debtor in possession model. It also reviewed the potential alternatives to the debtor in possession model, which include the mandatory appointment of a trustee (as under Chapter X of the 1898 Bankruptcy Act), a receiver, or an administrator to replace the debtor's management as of the petition date. In these alternative structures, management could stay in place and continue to work for the debtor, but it would be stripped of all management powers, which would then be vested in the trustee, receiver, or administrator. Moreover, the trustee, receiver, or administrator could terminate the employment of the debtor's management altogether.

The Commissioners debated the potential utility of a third-party manager to the bankruptcy estate. The Commission determined that these third-party alternatives could add the most value to cases involving fraudulent or incompetent management. The Commissioners acknowledged, as discussed further below, that section 1104 of the Bankruptcy Code currently mandates the appointment of a trustee in such cases.[88] The Commission also considered that in recent years many countries have adopted some form of the debtor in possession model either in lieu of or as an alternative (at the

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[86] For a general discussion of the parties overseeing the debtor in possession in chapter 11, *see* Butler, et al., *supra* note 77. *See also* 11 U.S.C. § 1103 (detailing duties of statutory committees; *id.* § 1104 (appointment of trustee); *id.* § 1109 (explaining standing of parties in interest).

[87] Courts generally defer to the fiduciary duties of the debtor in possession's directors and officers under applicable state law. *See, e.g.*, *In re* Schipper, 933 F.2d 513, 515 (7th Cir. 1991) (applying state law fiduciary duties and rejecting common law or other duties akin to those of a trustee). The case law concerning the beneficiary of these duties is mixed, with some courts suggesting, for example, that the duties might be owed to the estate, specific creditors, or all creditors, while others again defer to state law. *See, e.g.*, Petit v. New Eng. Mortg. Servs. Inc., 182 B.R. 64, 69 (D. Me. 1995) (quoting *In re* Ionosphere Clubs, Inc., 113 B.R. 164, 169 (Bankr. S.D.N.Y. 1990)) ("[D]ebtor in possession is a fiduciary of the creditors and, as a result, has an obligation to refrain 'from acting in a manner which could damage the estate, or hinder a successful reorganization.'") (citation omitted). *See also In re* Brook Valley VII, Joint Venture, 496 F.3d 892, 900 (8th Cir. 2007) ("Debtors in possession and those who control them owe fiduciary duties to the bankruptcy estate. The fiduciary obligations consist of two duties: the duty of care and the duty of loyalty."); *In re* Coram Healthcare Corp., 271 B.R. 228, 235 (Bankr. D. Del. 2001) ("The DIP must not self-deal, cannot act with a conflict of interest and must not take actions which are improper."). As explained below, the Commission addressed these issues in its deliberations.

[88] 11 U.S.C. § 1104(a) (providing that, upon the request of a party in interest or the U.S. Trustee, the court *shall* appoint a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management, either before or after the commencement of the case, or similar cause") (emphasis added). In addition, section 1104(e) provides: "The United States trustee shall move for the appointment of a trustee under subsection (a) if there are reasonable grounds to suspect that current members of the governing body of the debtor, the debtor's chief executive or chief financial officer, or members of the governing body who selected the debtor's chief executive or chief financial officer, participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting." 11 U.S.C. § 1104(e).

company's election) to a receiver or administrator.[89] This trend suggests broad recognition of the potential benefits of allowing the honest-but-unfortunate company debtor to lead its own restructuring efforts. Thus, on balance, the Commission concluded that the potential value of a mandatory trustee-like actor was significantly outweighed by the potential disruption, costs, and inefficiencies associated with the displacement of the debtor's management. Accordingly, the Commission recommended retention of the debtor in possession model.

As part of that decision, the Commission also agreed that directors, officers, and similar managing persons who operate a business in chapter 11 should remain subject to their state law fiduciary duties.[90] The Commissioners analyzed whether creating a new fiduciary standard under federal bankruptcy law would better serve the purposes of the Bankruptcy Code. Any federal standard would incorporate the traditional duties of care and loyalty, as well as good faith either as a subset of the duty of loyalty or an independent duty.[91] As the Commissioners discussed this possibility, they recognized significant value in aligning the fiduciary duties of the debtor in possession's management with state law fiduciary duties. This approach lends consistency to the process and is informed by the wealth of case law discussing state law fiduciary duties.

The Commissioners also discussed the potential conflicts in duties that could result from federalizing the fiduciary duties of directors, officers, and similar managing persons. For example, most state laws provide that directors, officers, and similar managing persons owe a fiduciary duty to the company, which is enforceable by its shareholders when the company is solvent and also by its creditors when it is

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[89] *See, e.g.*, Business Continuity Act of 31 Jan. 2009 (Belgium: debtor remains in control during moratorium period with limited control by the court); Companies' Creditors Arrangement Act (Canada: debtor remains in control and is assisted by a court appointed monitor frequently selected by the debtor); *Insolvenzordnung*, German Insolvency Act §§ 80, 270 (Germany: provides for "self-administration" in which the debtor works to reorganize under the surveillance of a supervisor; debtor may elect self administration provided that there are "no facts known which give reason to expect that the order will lead to disadvantages to the creditors"); Civil Rehabilitation Act (Japan: debtor remains in control and is monitored by a supervisor).

[90] This Report refers to "***applicable state entity governance law***" to capture not only state corporate law, but also applicable state law governing unincorporated entities (*e.g.*, partnerships, limited liability companies, etc.). In addition, references to "board of directors" and "directors, officers, and similar managing persons" are intended to refer to the individuals or entities acting on behalf of unincorporated entities in capacities similar to those of the board, directors, and officers in the corporate context.

[91] *See, e.g.*, Lange v. Schropp (*In re* Brook Valley VII, Joint Venture), 496 F.3d 892, 900 (8th Cir. 2007) (explaining that, in the bankruptcy context, "[t]he fiduciary obligation consists of two duties: the duty of care and the duty of loyalty"); Ad Hoc Comm. of Equity Holders of Tectonic Network, Inc. v. Wolford, 554 F. Supp. 2d 538, 558 n.135 (D. Del. 2008) (duty of good faith is a subset of the duty of loyalty in the bankruptcy context); Unif. P'ship Act § 404 (1997) (fiduciary duties of partners in partnership). *See also* Gantler v. Stephens, 965 A.2d 695, 708–09 (Del. 2009) ("In the past, we have implied that officers of Delaware corporations, like directors, owe fiduciary duties of care and loyalty, and that the fiduciary duties of officers are the same as those of directors. We now explicitly so hold.") (citation omitted); Stone v. Ritter, 911 A.2d 362, 369–70 (Del. 2006) ("The failure to act in good faith may result in liability because the requirement to act in good faith 'is a subsidiary element[,]' *i.e.*, a condition, 'of the fundamental duty of loyalty.'") (quoting Guttman v. Huang, 823 A.2d 492, 506 n.34 (Del. Ch. 2003)); Lyman P.Q. Johnson & Mark A. Sides, *The Sarbanes-Oxley Act and Fiduciary Duties*, 30 Wm. Mitchell. L. Rev. 1149, 1205–06 (2004) ("Although often overlooked, corporate officers, including senior officers such as the Chief Executive Officer, the Chief Financial Officer, Chief Technology Officer, General Counsel, Executive Vice Presidents, the Treasurer, the Secretary, and others are 'agents' of the corporation. Agency is a fiduciary relationship. Even though senior officers of corporations typically have employment agreements, they still occupy a fiduciary status in relation to the corporate principal.") (citations omitted).

insolvent.[92] Some courts have suggested that this allocation of rights between shareholders and creditors shifts as a company approaches insolvency (i.e., the "zone of insolvency"), but many courts tend to maintain the status quo until the company becomes insolvent.[93] If the Bankruptcy Code imposed separate duties on a debtor in possession's directors, officers, or similar managing persons, those duties might differ from the duties owed by those individuals under state law. Although federal

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[92] *See* United States v. Byrum, 408 U.S. 125, 138 (1972) ("[T]he directors . . . have a fiduciary duty to promote the interests of the corporation."); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 99 (Del. 2007) ("It is well established that the directors owe their fiduciary obligations to the corporation and its shareholders."); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 179 (Del. 1986) ("[T]he directors owe fiduciary duties of care and loyalty to the corporation and its shareholders."); Woodward v. Andersen, 627 N.W.2d 742, 751 (Neb. 2001) ("An officer or director of a corporation . . . occupies a fiduciary relation toward the corporation and its stockholders, and is treated by the courts as a trustee."). *See, e.g.*, N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007) ("When a solvent corporation is navigating in the zone of insolvency, the focus for Delaware directors does not change: directors must continue to discharge their fiduciary duties to the corporation and its shareholders by exercising their business judgment in the best interests of the corporation for the benefit of its shareholder owners."); Quadrant Structured Prods. Co. v. Vertin, 2014 Del. Ch. LEXIS 193, at *58 (Del. Ch. Oct. 1, 2014) ("In a solvent corporation, the standard of conduct for directors requires that they strive in good faith and on an informed basis to maximize the value of the corporation for the benefit of its residual claimants, the ultimate beneficiaries of the firm's value. In a solvent corporation, the residual claimants are the stockholders. Consequently, in a solvent corporation, the standard of conduct requires that directors seek prudently, loyally, and in good faith to manage the business of a corporation for the benefit of its shareholder owners."); *In re* Bear Stearns Litig., 23 Misc. 3d 447, 475 (N.Y. Sup. Ct. 2008) ("The directors still have the 'duty to maximize the value of the insolvent corporation for the benefit of those having an interest in it' and are required to 'engage in vigorous, good faith negotiations with individual creditors for the benefit of the corporation.'") (citing N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 103 (Del. 2007)); Dodge v. Ford Motor Co., 170 N.W. 668, 684 (Mich. 1919) ("A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes."). *See also* James Gadsden, *Enforcement of Directors' Fiduciary Duties in the Vicinity of Insolvency*, Am. Bankr. Inst. J., Feb. 2005, at 16 ("The corporation laws of all states agree that directors owe fiduciary duties to the corporation."); Royce de R. Barondes, *Fiduciary Duties of Officers and Directors of Distressed Corporations*, 7 Geo. Mason L. Rev. 45, 63 (1998) (explaining that when the corporation reaches insolvency, "[t]he majority rule, and the law in Delaware, is that . . . a board's duties are owed to the creditors of the enterprise"); Bruce A. Markell, *The Folly of Representing Insolvent Corporations: Examining Lawyer Liability and Ethical Issues Involved in Extending Fiduciary Duties to Creditors*, 6 Norton J. Bankr. L. & Prac. 403, 404 (1997) ("Indeed, [when a company is solvent], most states impose fiduciary duties of loyalty and care on the directors and officers in favor of shareholders."); Ramesh K.S. Rao, et al., *Fiduciary Duty a la* Lyonnais*: An Economic Perspective on Corporate Governance in a Financially-Distressed Firm*, 22 J. Corp. L. 53, 64 (1996) (explaining that "[a]s the firm slides into insolvency," fiduciary responsibilities are "extended to creditors in order to ensure adequate protection of their interests"); Jeffrey N. Gordon, *Corporations, Markets, and Courts*, 91 Colum. L. Rev. 1931, 1977 (1991) (shareholder wealth maximization is "the bedrock of corporate law"). *But see* Margaret M. Blair & Lynn A. Stout, *Specific Investment: Explaining Anomalies in Corporate Law*, 31 J. Corp. L. 719, 731 (2006) ("There is very little in corporate law that supports [shareholder wealth maximization] and much that cuts against it.").

[93] *See, e.g.*, Berg & Berg Enters., LLC v. Boyle, 100 Cal. Rptr. 3d 875, 894 (Ct. App. 2009) ("[W]e hold that there is no fiduciary duty prescribed under California law that is owed to creditors by directors of a corporation solely by virtue of its operating in the 'zone' or 'vicinity' of insolvency.") (using the trust fund doctrine to determine the directors' fiduciary duties); N. Am. Catholic Educ. Programming Found., Inc. v. Gheewalla, 930 A.2d 92, 101 (Del. 2007). *But see* Geiger & Peters, Inc. v. Berghoff, 854 N.E.2d 842, 850 (Ind. Ct. App. 2006) ("Indiana does not adhere to the 'trust fund' theory . . . ."); St. James Capital Corp. v. Pallet Recycling Assocs. of N. Am., Inc., 589 N.W.2d 511, 516 (Minn. Ct. App. 1999) ("'Corporate property is not held in trust'. . . . [C]reditors have the right to be repaid, [but] it is equally true that they do not have the right, absent an agreement to the contrary, to dictate what course of action the directors and officers of a corporation shall take in managing the company . . . .") (citation omitted).

preemption principles might resolve such conflicts from a legal perspective, the conflict could cause substantial confusion and uncertainty for directors, officers, and similar managing persons. The Commission agreed that state law adequately governs fiduciary duties and should continue to govern the fiduciary duties of directors, officers, and similar managing persons in bankruptcy.

2. The Chapter 11 Trustee

Recommended Principles:

- The standard for appointing a chapter 11 trustee under section 1104(a) of the Bankruptcy Code should not change.
- The burden of proof with respect to requests for the appointment of a chapter 11 trustee under section 1104(a) should be based on the preponderance of the evidence standard. Case law requiring application of the clear and convincing standard should be overturned by statutory amendment.
- As is currently provided by section 1104(d), the U.S. Trustee should continue to select and appoint a disinterested person to serve as chapter 11 trustee after the court enters an order under section 1104(a) directing such appointment and after consultation with parties in interest.[94]
- A party in interest should be able to object to the person appointed as the chapter 11 trustee. An objecting party should plead with particularity the facts supporting its objection. The objection should be filed and heard on an expedited basis. The court should approve the person appointed by the U.S. Trustee unless the objecting party establishes by clear and convincing evidence that: (1) the U.S. Trustee did not properly consult with parties in interest; (2) the person selected is not eligible to serve as trustee under section 321; (3) the person selected has not qualified to serve as trustee under section 322; (4) the person selected is not disinterested; or (5) the person selected has a disqualifying conflict of interest. If an objection is filed, the court should approve or disapprove the person appointed as chapter 11 trustee by the U.S. Trustee, but the court should not otherwise be involved in the chapter 11 trustee selection process.
- Section 1104(b), which provides for the election of a chapter 11 trustee, should be deleted.
- Once appointed, the chapter 11 trustee may take any actions and exercise any powers with respect to the estate as authorized under section 1106 without the approval or consent of the debtor, the debtor's board of directors (or similar governing body), any of the debtor's officers or similar managing persons, or the debtor's equity security holders.
- The appointment of a chapter 11 trustee should not terminate the debtor's exclusivity period to file, or its time to solicit acceptances of, a plan, but should preserve such exclusivity period solely for the benefit of the trustee.

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[94] Bankruptcy cases in Alabama and North Carolina are not under the jurisdiction of the U.S. Trustee, but rather are administrated by Bankruptcy Administrators in those jurisdictions. Accordingly, the applicable rules of those jurisdictions would govern the appointment process.

> Accordingly, the trustee should receive the benefit of any remaining exclusivity period under section 1121, provided that a party in interest should be able to file a motion seeking to shorten or terminate such period as provided in section 1121(d). Section 1121(c)(1) should be amended accordingly.

a. The Chapter 11 Trustee: Background

A trustee is appointed in a chapter 11 case only upon a motion of a party in interest or the U.S. Trustee and the entry of an order of the court granting such motion. Section 1104 of the Bankruptcy Code provides that the court shall order the appointment of a trustee "for cause, including fraud, dishonesty, incompetence, or gross mismanagement of the affairs of the debtor by current management" or "if such appointment is in the interests of creditors, any equity security holders, and other interests of the estate."[95] In addition, section 1104(e) requires the U.S. Trustee to file a motion requesting a trustee "if there are reasonable grounds to suspect that current [management] . . . participated in actual fraud, dishonesty, or criminal conduct in the management of the debtor or the debtor's public financial reporting."[96]

Notwithstanding this statutory authority, anecdotal evidence suggests that chapter 11 trustees are the rare exception rather than the rule.[97] The paucity of cases in which chapter 11 trustees serve may suggest that the overall system is working and that stakeholders either have confidence in the debtor's management or have replaced troublesome managers prior to or shortly after the petition date.[98] Parties in interest may also be using the possibility of seeking the appointment of a trustee in negotiations with the debtor in a way that fosters meaningful results and eliminates the need for a trustee.[99] A case warranting a chapter 7 trustee may convert to a case under chapter 7 of the Bankruptcy Code, thereby eliminating the need for a chapter 11 trustee.[100] Some contend that a systemic antipathy to reorganization trustees, arising from pre-Bankruptcy Code practice, found its way into early decisions that construed the language of the Bankruptcy Code.[101] For example, courts may be discouraging parties from filing motions requesting the appointment of a chapter 11 trustee by applying the clear and convincing standard to the determination.[102] Parties in interest also may fear

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[95] 11 U.S.C. § 1104(a)(1), (2).

[96] *Id.* § 1104(e).

[97] *See, e.g.*, Dickerson, *supra* note 19, at 888–900 (explaining that "[t]hough the Code provides that managers can be replaced or supervised by a public trustee, trustee appointments are, and always have been, rare"); Kelli A. Alces, *Enforcing Corporate Fiduciary Duties in Bankruptcy*, 56 U. Kan. L. Rev. 83, 84–85 (2007) (noting rarity of chapter 11 trustees).

[98] *See, e.g.*, John D. Ayer, et al., *Bad Words to a Debtor's Ear*, Am. Bankr. Inst. J., Mar. 2005, at 20 ("Creditors force out the old management before the chapter 11 begins, and so the nominal 'DIP' is someone in whom creditors have faith, sent in to clean up the mess that others left behind.").

[99] *See, e.g.*, Stuart C. Gilson & Michael R. Vetsuypens, *Creditor Control in Financially Distressed Firms: Empirical Evidence*, 72 Wash. U. L.Q. 1005, 1012 (1994) (discussing creditors' threats to petition the court to appoint a trustee if managers do not resign).

[100] *See, e.g.*, Ayer et al., *supra* note 98.

[101] Clifford J. White III & Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners after BAPCPA*, 80 Am. Bankr. L.J. 289, 314–15 (2006).

[102] *See, e.g., In re* G-I Holdings, Inc., 385 F.3d 313 (3d Cir. 2004) (applying clear and convincing standard). *But see* Tradex Corp. v. Morse, 339 B.R. 823 (D. Mass. 2006) (applying preponderance of the evidence standard).

retribution by the debtor or other stakeholders if the court denies the motion, or may prefer having individuals with whom they are familiar (even if they do not like or necessarily trust them) rather than an individual they do not know. Moreover, some parties may raise concerns regarding the costs associated with chapter 11 trustees, which may be driven by a perception that chapter 11 trustees are inclined toward litigation to ensure that they fulfill their fiduciary duties to the estate.[103]

If the court enters an order appointing a chapter 11 trustee, the U.S. Trustee identifies a disinterested and qualified individual to serve as the trustee.[104] Section 1104(d) requires the U.S. Trustee to consult with parties in interest during this process, and the selection is subject to court approval.[105] Although section 1104(d) is silent on the scope of court review, the court generally will review only whether the U.S. Trustee consulted with parties as required by the Bankruptcy Code and whether the candidate is disinterested and is formally qualified to serve as trustee. A party in interest may also request that the U.S. Trustee hold an election for the trustee in accordance with section 702 of the Bankruptcy Code.[106]

Once identified and approved, the chapter 11 trustee assumes all of the powers of the debtor's management, is vested with certain other powers, and is subject to certain duties under section 1106 of the Bankruptcy Code. The trustee can, among other things, operate the debtor's business, manage and administer the bankruptcy estate, file and implement a chapter 11 plan, and investigate the debtor's affairs and pre-petition activities.[107] The trustee must also ensure that certain materials and reports are filed with the court on a timely basis.

b. The Chapter 11 Trustee: Recommendations and Findings

The debtor in possession model should not be the sole structure for a chapter 11 case. The Bankruptcy Code needs an effective mechanism for appointing a chapter 11 trustee to displace management in appropriate cases. The Commissioners discussed the kinds of cases that warrant chapter 11 trustees, including instances of fraud or illegal conduct by management. They also acknowledged the value of appointing a trustee to increase accountability in chapter 11 cases, to protect against "bankruptcy rings" and collusive conduct, and to create dynamic tension by introducing an outsider to the

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[103] In addition, the increasing use of chief restructuring officers, at least in larger chapter 11 cases, may suggest that parties are working around the concerns often associated with chapter 11 trustees.

[104] *See* Clifford J. White III & Walter W. Theus, Jr., *Taking the Mystery Out of the Chapter 11 Trustee Appointment Process*, Am. Bankr. Inst. J., May 2014 ("Beyond independence, the U.S. Trustee will consider a candidate's experience, qualifications and ability to muster necessary bankruptcy, financial and business expertise."). Bankruptcy cases in Alabama and North Carolina are not under the jurisdiction of the U.S. Trustee, but rather are administrated by Bankruptcy Administrators in those jurisdictions.

[105] 11 U.S.C. § 1104(a). *See also* Chapter 11 Trustee Handbook 7 (May 2004) (explaining that the U.S. Trustee consults, either by telephone or in person, with parties in interest to identify candidates and then interviews potential candidates to determine if they are qualified for the particular case and disinterested); White & Theus, *supra* note 104 ("Once the court enters the order, the U.S. Trustee expeditiously consults with major creditors, the creditors' committee, the debtor and other interested parties. This consultation might be in person, by telephone or by email. U.S. Trustees take seriously and place a high value on the input provided by parties in interest.").

[106] 11 U.S.C. § 1104(b) (providing that motion requesting an election must be filed within 30 days of the entry of the order appointing a chapter 11 trustee).

[107] *Id.* § 1106(a).

negotiation process.[108] As referenced in the previous section, however, the Commissioners also evaluated the potential disadvantages of appointing a trustee, such as the potential collateral impact of the appointment, additional costs, delays, and inefficiencies in the case. In light of the foregoing, the Commission determined to retain the grounds for the appointment of a chapter 11 trustee set forth in section 1104(a) because they are warranted and strike an appropriate balance between the benefits and drawbacks of such appointment.

The Commission also considered the relatively low percentage of trustee appointments in chapter 11 cases. It was not able to determine if the relatively small number of trustee appointments suggested a flaw in the current system or reflected the judgment of stakeholders that grounds either did not exist to support an appointment or were remedied through pre-petition changes in management. The Commissioners were persuaded by the suggestion that the burden of proof governing a motion to appoint a chapter 11 trustee under section 1104 could influence the decision of a party in interest to file such a motion in the first place. Indeed, courts often expressly state that the appointment of a chapter 11 trustee is the exception and that the standard for approval is very high.[109] The Commissioners evaluated the potential chilling effect of requiring the moving party to demonstrate the need for a trustee by clear and convincing evidence and the justifications for this standard.[110] They also discussed whether a lower standard, such as the preponderance of the evidence standard, could be subject to abuse and cause unnecessary distractions in the chapter 11 case.

The Commissioners carefully weighed the competing considerations and relevant policy objectives underlying the debtor in possession model and the Bankruptcy Code. Reflecting on the discussion of cases that may warrant and benefit from a trustee, the Commission determined that the lower preponderance of the evidence standard — and not the clear and convincing evidence standard — should apply to motions to appoint a chapter 11 trustee under section 1104(a). This change is likely to not only encourage parties in interest to seek the appointment of a chapter 11 trustee in appropriate cases, but it would also resolve a split among the courts on this important legal issue.

The Commissioners also discussed their various experiences with trustees in chapter 11 cases and acknowledged that, particularly in cases involving massive fraud by the debtor, chapter 11 trustees have served with distinction.[111] They discussed the

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[108] For a historical overview of the purpose of the U.S. Trustee in response to so-called "bankruptcy rings," *see* 6 Collier On Bankruptcy ¶ 6.01 (Alan N. Resnick & Henry J. Sommer eds., 16th ed.) ("[I]n many parts of the country, the Bankruptcy Act principle of creditor control of cases had degenerated into a system of attorney control. That fostered the development of 'bankruptcy rings,' closed bankruptcy practices heavily favoring the appointment of insiders, who were obliged to one another, to trustee positions. Cases were too often administered solely for the benefit of the members of the bankruptcy rings, with creditors receiving nothing.").

[109] *See, e.g., In re* Taub, 427 B.R. 208, 225 (Bankr. E.D.N.Y. 2010) ("The appointment of a trustee is an unusual remedy and '[t]he standard for § 1104 appointment is very high . . . .'") (quoting Adams v. Marwil (*In re* Bayou Grp., LLC), 564 F.3d 541, 546 (2d Cir. 2009)).

[110] *See, e.g., In re* LHC, LLC, 497 B.R. 281, 291 (Bankr. N.D. Ill. 2013) ("Applying the clear and convincing evidence standard appears . . . to be more consistent with the presumptions that a debtor should generally be permitted to remain in control and possession of its business and that the appointment of a Chapter 11 trustee is an extraordinary remedy.") (citation omitted).

[111] *But see Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("MFA therefore suggests that Congress should make clear that parties in interest and the U.S. Trustee may seek appointment of a trustee in circumstances

value of having the U.S. Trustee, as an independent agency with no financial stake in the case, identify and vet trustee candidates, because multiple stakeholders may have competing interests in the selection process.

The Commission reviewed at length the current consultation process and believed that the U.S. Trustee should, as under current law, continue to consult with parties in interest to both identify potential candidates and to better understand the needs and circumstances of the particular case. The Commission did not find any value in imposing a public meeting requirement on the trustee selection process; rather, all evidence indicates that the private consultation practice currently in place works well, and imposing a public meeting requirement is likely to add cost and delay to the process and to chill participation and openness.

The Commission considered whether the election process incorporated into section 1104(b) provides stakeholders with a sufficient alternative to a candidate selected by the U.S. Trustee. In theory, the election process should enable stakeholders to nominate directly and then to vote on qualified candidates. Unfortunately, the anecdotal evidence suggests that stakeholders rarely request an election process and are skeptical that the process benefits the estate for at least two reasons. First, it is hard to displace a trustee that has already been put in place, even if a different person with greater support among the constituents might have been picked in the first instance. Second, several of the major constituencies are not entitled to vote under section 1104(b), including secured creditors and unions.[112]

The Commissioners found the election process unsatisfactory in light of these concerns. Consequently, the Commission considered alternative ways to provide all stakeholders with a stronger voice in the trustee-selection process, based on the belief that such a process may further mitigate any resistance to trustee appointment in appropriate cases. The Commissioners discussed a variety of ways to allow stakeholders to voice objections to trustee candidates and to have some role in the selection process. In exploring these alternatives, the Commissioners were very mindful of the need for the U.S. Trustee to maintain flexibility and discretion as the independent appointing official. Allowing the court or stakeholders to second-guess the U.S. Trustee's decision too easily could come with substantial costs, including introducing bias into the process and paralyzing the debtor's reorganization efforts while parties in interest attempt to agree on a trustee candidate.

Section 1104(d) provides for court approval of the U.S. Trustee's trustee appointments, but does not specify any grounds upon which the court may disapprove an appointment. Furthermore, parties in interest are given no role in the appointment approval process. The Commission concluded that specifying grounds for disapproval and providing stakeholders with a more defined ability to object to the U.S. Trustee's

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other than fraud – where management entrenchment, misalignment of interests or other factors have significantly impaired the reorganization process such that a neutral third party is necessary to break the logjam. Appointment of a trustee should be authorized if the court believes that a trustee will be better equipped than management to navigate competing interests and facilitate a successful reorganization. The preference of all creditors should be taken into account – both in the appointment of an interim trustee and in any subsequent election.").

[112] Eligibility to vote for the trustee is determined by section 702 of the Bankruptcy Code. In order to vote, creditors must, among other things, hold an allowable undisputed, fixed, liquidated, and unsecured claim. Secured creditors are thus not eligible to vote because their claim is not unsecured, and unions are frequently not eligible to vote because their claims are contingent, disputed, or unliquidated.

appointment would be beneficial. The Commissioners explored how to discourage frivolous objections and to encourage full disclosure in a manner that informed the parties and the court about the issues relevant to the appointment of the trustee. The Commission determined that any objections should be pled with particularity and that the objection process should incorporate a strong presumption favoring the U.S. Trustee's candidate. The court should approve the person appointed by the U.S. Trustee unless the objecting party establishes by clear and convincing evidence that: (1) the U.S. Trustee did not properly consult with parties in interest; (2) the person selected is not eligible to serve as trustee under section 321 of the Bankruptcy Code; (3)the person selected has not qualified to serve as trustee under section 322 of the Bankruptcy Code; (4) the person selected is not disinterested; or (5) the person selected has a disqualifying conflict of interest. A court should not reject the U.S. Trustee's selection based on a party in interest's assertion that another individual would better serve the estate or is better qualified for the position. Moreover, neither the court nor the objecting party should be able to displace the U.S. Trustee in the appointment process. The court should only be able to approve or disapprove the U.S. Trustee's appointment. If the court disapproves an appointment, the U.S. Trustee should still maintain control of the appointment process by vetting additional candidates and making a substitute appointment.

Once a chapter 11 trustee has been appointed, the Commission found that the current process works for vesting the trustee with all control and management authority concerning the debtor and the estate. Specifically, if grounds exist to warrant the appointment, the chapter 11 trustee should be able to take any actions and exercise any powers with respect to the estate as authorized under section 1106 without the approval or consent of the debtor, the debtor's board of directors (or similar governing body), any of the debtor's officers or similar managing persons, or the debtor's equity security holders. Accordingly, the chapter 11 trustee should, for example, be able to cause the estate to retain managers and employees deemed necessary to the reorganization process, but such personnel should act only under the supervision of the trustee.

The Commissioners debated whether the debtor's exclusivity periods to file a plan and solicit acceptances of a plan should terminate upon the appointment of a trustee. The Commissioners explored why termination may be appropriate; indeed, displacement of the debtor's management suggests a need for different approaches to the reorganization, and stakeholders should have some say in the new process. The trustee, however, is appointed in large part to facilitate this new direction and should have some ability to negotiate with the various stakeholders to try to reach a resolution that benefits the estate and its stakeholders. Accordingly, the Commission determined that if the debtor has any remaining exclusivity periods under section 1121 at the time of the trustee's appointment, the trustee should be able to step into the shoes of the debtor and receive the benefit of such remaining exclusivity periods, but should not be able to seek extensions of those periods.

In discussing the chapter 11 trustee appointment process, as well as the estate neutral appointment process described below, the Commission considered the current dual system for bankruptcy administration: (i) U.S. Trustees for 48 states, Puerto Rico, the U.S. Virgin Islands, and Guam; and (ii) Bankruptcy Administrators for Alabama

and North Carolina. The Office of the U.S. Trustee operates as a division of the Department of Justice, and the Executive Office for U.S. Trustees coordinates and oversees the activities of the U.S. Trustees in 21 regional offices.[113] This structure promotes uniformity and consistency in the application of federal bankruptcy laws. The Bankruptcy Administrator programs are separately administered in each state through the judiciary in those states.[114]

The Commissioners debated the efficiency of continuing these two separate systems. Some Commissioners believed that unifying the administration and oversight of bankruptcy cases in all jurisdictions under the Office of the U.S. Trustee would promote the uniformity in the application of federal bankruptcy laws as envisioned by the Bankruptcy Clause of the Constitution[115] and would serve the interests of parties in the system. They encouraged the Commission to recommend making the U.S. Trustee program a national program that would be responsible for bankruptcy administration in all 50 states, as well as Puerto Rico, the U.S. Virgin Islands, and Guam. Other Commissioners expressed a concern that this issue was not directly within the scope of the Commission's mandate. Consequently, the Commission decided not to address this matter.

3. The Estate Neutral

Recommended Principles:

- The Bankruptcy Code should be amended to delete any reference to an "examiner" and to incorporate the concept of a more flexible "estate neutral," as described in these principles.
- Section 1104(c) of the Bankruptcy Code should be amended to set forth the standards for, and potential authority and duties of, an estate neutral, as described in these principles.
- Section 1104(c) should not mandate the appointment of an estate neutral in any circumstances.
- The court should be permitted to order the U.S. Trustee to appoint an estate neutral if (i) a trustee is not appointed and (ii)(a) the appointment is in the best interests of the estate, or (b) for cause.[116]
- An order directing the U.S. Trustee to appoint an estate neutral should specify the scope of the estate neutral's duties and the duration of the appointment. The court may direct the U.S. Trustee to appoint more than one estate neutral in any given case to serve different functions if necessary or

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[113] For more information about U.S. Trustees and the Executive Office for the U.S. Trustees, *see U.S. Trustee Program*, http://www. justice.gov/ust/index.htm.

[114] For more information about Bankruptcy Administrators, *see Bankruptcy Administrators*, http://www.uscourts.gov/ FederalCourts/Bankruptcy/BankruptcyAdministrators.aspx.

[115] U.S. Const. art. I, § 8, cl.4. *See also* Charles Jordan Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, 2015 Ill. L. Rev. , at *1 (forthcoming 2015) (noting that the powers granted to Congress under the Bankruptcy Clause are extremely broad), *available at* http://ssrn.com/abstract=2516841.

[116] Bankruptcy cases in Alabama and North Carolina are not under the jurisdiction of the U.S. Trustee, but rather are administrated by Bankruptcy Administrators in those jurisdictions. Accordingly, the applicable rules of those jurisdictions would govern the appointment process.

warranted by the circumstances of the case. Nevertheless, the Bankruptcy Code should include a presumption against the appointment of more than one estate neutral in any given case.

- An order directing the U.S. Trustee to appoint an estate neutral should not permit that individual to: (i) propose a chapter 11 plan for the debtor; (ii) act as a mediator in any matter affecting the chapter 11 case, unless such action is the primary purpose of the individual's original appointment; (iii) initiate litigation on behalf of the debtor or the estate, unless such action is within the scope of the individual's original appointment and the individual was not previously engaged to investigate or examine matters relating to the litigation or the debtor's chapter 11 case; or (iv) except as provided in the principles for small and medium-sized enterprise cases, operate the debtor's business.
- Upon the entry by the court of an order directing the U.S. Trustee to appoint an estate neutral, the U.S. Trustee should, in conformity with the procedures established for the appointment of a chapter 11 trustee, appoint a disinterested person to serve as the estate neutral. A party in interest should have the ability to object to the person appointed as the estate neutral under the same procedures and subject to the same standards established in the principles governing objections to the person appointed as the chapter 11 trustee. See Section IV.A.2, *The Chapter 11 Trustee*.

a. The Estate Neutral: Background

A chapter 11 trustee is not the only alternative to the debtor in possession. An examiner with a specific directive may be appointed to investigate the affairs of the debtor.[117] An examiner does not displace the debtor in possession or its management, and it is available only if no trustee has been appointed and only upon request of a party in interest or the U.S. Trustee and after notice and a hearing. In those circumstances, section 1104(c) requires the court to appoint an examiner if such appointment is in the interests of creditors, equity security holders, or the estate, or if "the debtor's fixed, liquidated, unsecured debts, other than debts for goods, services, or taxes, or owing to an insider, exceed $5,000,000."[118]

Whether the appointment of an examiner is truly mandatory in any given case has met with resistance by some courts and created a split in the law.[119] Professor Jonathan

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[117] For a general discussion of the role and appointment of examiners in chapter 11 cases, *see* Jonathan C. Lipson, *Understanding Failure: Examiners and the Bankruptcy Reorganization of Large Public Companies*, 84 Am. Bankr. L.J. 1 (2010).

[118] 11 U.S.C. § 1104(c).

[119] *See, e.g.*, *In re* Wash. Mutual, Inc., 442 B.R. 314, 324 (Bankr. D. Del. 2011) ("The Court denied the Initial Examiner Motion . . . finding that there was no appropriate scope for an examiner to conduct an investigation given that issues pertinent to, and even beyond the scope of, the chapter 11 cases had been 'investigated to death.'"); *In re* Spansion, Inc., 426 B.R. 114, 127 (Bankr. D. Del. 2010) ("I find no sound purpose in appointing an examiner, only to significantly limit the examiner's role when there exists insufficient basis for an investigation. To appoint an examiner with no meaningful duties strikes me as a wasteful exercise, a result that could not have been intended by Congress."); *In re* Erickson Ret. Communities, LLC, 425 B.R. 309, 312 (Bankr. N.D. Tex. 2010) ("At first blush, the issue here seems to be whether, because the $5 million unsecured debt threshold is met . . . the appointment of an examiner is mandatory. Many courts have been confronted with this issue and have held yes — an examiner is required whenever the $5 million unsecured debt threshold of Section 1104(c)(2) is met. This court agrees with

C. Lipson reviewed "dockets from 576 of the largest chapter 11 cases commenced between 1991 and 2007" and discovered that "examiners were requested in only 87 cases, or about 15 percent of the sample," and that the "motions were granted in only 39 cases, less than half of cases where [an examiner was] sought, and about 6.7 percent of all cases in the sample."[120] Professor Lipson concluded that despite statements by some commentators to the contrary, examiners "are neither 'routinely' sought nor 'automatically' appointed in large cases."[121] Professor Lipson also concluded that examiners were more likely appointed in "huge," contentious cases, and that a request for the appointment of a trustee increases the odds that an examiner will be appointed.[122]

Setting aside the debt threshold in section 1104(c)(2), courts have generally interpreted the "interests" test in section 1104(c)(1) to broadly encompass the interests of all parties in interest. As one court explained, "the basic job of an examiner is to examine, not to act as a protagonist in the proceedings."[123] For this reason, "appointment under section 1104(c)(1) must, therefore, be in the interests of everyone with a stake in the case, including creditors, equity security holders, and other interests of the estate."[124] When only certain parties (i.e., the movants) would likely benefit from the appointment of an examiner, such request was not deemed to satisfy the "interests" test.[125] In deciding whether to appoint an examiner, courts have also considered the

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such courts that, where the $5 million unsecured debt threshold is met, a bankruptcy court ordinarily has no discretion. The only judicial discretion that comes into play is in defining the scope of the examiner's role/duties. The court can make the scope of an examiner's duties very broad or very narrow." (citations omitted)); *In re* Vision Dev. Grp. of Broward Cnty., LLC, 2008 WL 2676827, at *3 (Bankr. S.D. Fla. Jun 30, 2008) ("[A] request for, and appointment cannot be waived by request made late in case of, an examiner may be made 'at any time before the confirmation of the plan.'") (quoting 11 U.S.C. § 1104(c)(2)). *See also* Walton v. Cornerstone Ministries Invs., Inc., 398 B.R. 77, 81 (N.D. Ga. 2008) ("[E]very district court and nearly every bankruptcy court that has confronted the question has also read the provision to be mandatory on its face."); *In re* Schepps Food Stores, Inc., 148 B.R. 27, 30 (S.D. Tex. 1992) ("This reasoning is both grammatically and contextually wrong. In the provision, 'as is appropriate' modifies 'investigation.' The statute allows the court to determine the scope, length, and conduct of the investigation, rather than the appointment itself.").

[120] Jonathan C. Lipson, *Understanding Failure: Examiners and the Reorganization of Large Public Companies*, 84 Am. Bankr. L.J. 1 (2010). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[121] *Id.* at 4. Indeed, Professor Lipson includes this quote from the Honorable Robert Gerber of the U.S. Bankruptcy Court for the Southern District of New York: "[M]andatory appointment [of examiners] is terrible bankruptcy policy, and the Code should be amended . . . to give bankruptcy judges . . . the discretion to determine when an examiner is necessary and appropriate. . . ." *Id.*

[122] *Id.* at 5. Professor Lipson also notes that examiners are more likely to be sought in cases pending in Delaware or the Southern District of New York (where most of the "huge" cases are filed), and that allegations of fraud do not automatically result in either a request for, or order appointing, an examiner. *Id.*

[123] Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* W.R. Grace & Co.), 285 B.R. 148, 156 (Bankr. D. Del. 2002).

[124] *In re* Gliatech, Inc., 305 B.R. 832, 836 (Bankr. N.D. Ohio 2004) (citations omitted). Another court explained that "[a] single creditor group 'cannot justify the appointment of a[n] . . . examiner simply by alleging that it would be in its interests.'" *In re* Sletteland, 260 B.R. 657, 672 (Bankr. S.D.N.Y. 2001) (citations omitted). *See also In re* Lenihan, 4 B.R. 209, 212 (Bankr. D.R.I. 1980) ("[W]ill such an appointment benefit the estate of the debtor and the interests of creditors? A bankruptcy court, which must eventually pass upon questions of fairness, good faith, best interest, etc. prior to confirmation, cannot blindfolded by the tactical jockeying of the parties in determining what is in the interest of the estate.") (citations omitted).

[125] *See, e.g.*, *In re* Loral Space & Commc'ns Ltd., 313 B.R. 577, 583–84 (Bankr. S.D.N.Y. 2004), *rev'd and remanded on other grounds*, 2004 WL 2979785 (S.D.N.Y. Dec. 23, 2004) ("The Ad Hoc Committee's motion clearly fails the 'in the interests of the estate' test of section 1104(c)(1) of the Bankruptcy Code. First, under section 1104(c)(1) the appointment of an examiner must be in the interests of the estate in general. Here, however, the

overall financial benefit that an examiner could bring to the estate.[126] Allegations of corporate fraud and misconduct by a debtor's insiders or affiliates are often cited as reasons for appointing an examiner so that the examiner may investigate such allegations.[127]

It is noteworthy that although the language in section 1104 is not explicit, some courts and scholars have stated that the "interests" test for the appointment of examiners is the same "interests" test that is applied to the appointment of trustees: the "best interests" test.[128] This reasoning may be based on the fact that the "interests" test in section 1104(a) respecting trustee appointments and section 1104(c) respecting examiner appointments is substantially identical;[129] indeed, the statute does not explicitly provide for a "best interests" test.[130] If appointed, the primary duty of an examiner under current law is to (i) "conduct such an investigation of the debtor as is

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appointment of an examiner would, at best for the shareholders, advance only their interests in opposition to the Debtors' plan."). On appeal, the district court reversed and remanded to the bankruptcy court, mandating the appointment of an examiner but solely on the ground that "[o]n its face, Section 1104(c)(2) mandates the appointment of an examiner where a party in interest moves for an examiner and the debtor has $5,000,000 of qualifying debt." *In re* Loral Space & Commc'ns Ltd., 2004 WL 2979785, at *4 (S.D.N.Y. Dec. 23, 2004).

[126] *See, e.g., In re* Loral Space & Commc'ns Ltd., 313 B.R. 577, 584 (Bankr. S.D.N.Y. 2004), *rev'd and remanded on other grounds*, 2004 WL 2979785 (S.D.N.Y. Dec. 23, 2004) ("[T]he appointment of an examiner would not be in the estates' interest in the light of the negligible benefits of the requested valuation balanced against its cost."); *In re* Shelter Res. Corp., 35 B.R. 304, 305 (Bankr. N.D. Ohio 1983) ("The appointment of an examiner would entail undue delay in the administration of this estate and most likely cause the debtor to incur substantial and unnecessary costs and expenses detrimental to the interests of creditors and parties in interest."); *In re* Hamiel & Sons, Inc., 20 B.R. 830, 837 (Bankr. S.D. Ohio 1982) (conducting cost/benefit analysis when considering appointment of trustee or examiner).

[127] *See, e.g., In re* Keene Corp., 164 B.R. 844, 856 (Bankr. S.D.N.Y. 1994) ("Often, appointment of an examiner is warranted when the debtor's transactions with affiliates should be investigated.") (quoting M. Bienenstock, Bankruptcy Reorganization 299 (1987)). Another bankruptcy court appointed an examiner because it found that it was in the interest of creditors to involve an examiner in light of the significant amount of debt, receivables, and other obligations at stake and that "[t]he involvement of an examiner will contribute valuable perspective to a case with many competing interests at stake." *In re* First Am. Health Care of Ga., Inc., 208 B.R. 992, 995 (Bankr. S.D. Ga. 1996).

[128] *See In re* Lenihan, 4 B.R. 209, 211 (Bankr. D.R.I. 1980) (holding that the decision to appoint an examiner "rests on a determination by the court that such appointment would be in the *best interests* of creditors, equity security holders, and the estate; the same test used to determine whether the appointment of a trustee is warranted") (emphasis added); Ryan M. Murphy, *Does the Recent String of Examiner Appointments in Delaware Represent a Sea Change in Approach or Merely a Perfect Storm of Cases?*, Norton J. Bankr. L. 2011.04-2 (2011) ("[A] bankruptcy court is authorized to appoint an examiner under two scenarios: (1) where it is in the *best interest* of the estate and interested parties; or (2) where the debtor's fixed, unliquidated debts (excluding claims for goods, services, taxes and insider transactions) exceed $5 million.") (citations omitted) (emphasis added); 5 Norton Bankr. L. & Prac. 3d § 99:25 ("The 'best interests' test for the appointment of an examiner, like the Code § 1104(a)(2) provision for the appointment of a trustee6 is a flexible and discretionary standard.").

[129] Section 1104(a) provides that the court shall appoint a trustee if, among other reasons, "such appointment is in the interests of creditors, any equity security holders, and other interests of the estate." 11 U.S.C. § 1104(a)(2). Section 1104(c) provides that the court shall appoint an examiner if, setting the debt threshold aside, "such appointment is in the interests of creditors, any equity security holders, and other interests of the estate." 11 U.S.C. § 1104(c)(1).

[130] "Sections 1104(a)(2) and (c)(1) of the Bankruptcy Code, using identical language, authorize the appointment of a trustee or examiner, respectively, if 'such appointment is in the interests of creditors, any equity security holders, and other interests of the estate.' Under these provisions, a creditor group, no matter how dominant, cannot justify the appointment of a trustee or examiner simply by alleging that it would be in its interests. It must show that the appointment is in the interests of all those with a stake in the estate, which in this case would include the Debtor. As Collier points out, 'Use of the word 'and' suggests that creditors cannot on their own obtain the appointment of a trustee under the provision in order to disenfranchise equity security holders or other interests.'" *In re* Sletteland, 260 B.R. 657, 672 (Bankr. S.D.N.Y. 2001).

appropriate, including an investigation of any allegations of fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor of or by current or former management of the debtor"[131] and (ii) "(A) file a statement of any investigation conducted . . . including any fact ascertained pertaining to fraud, dishonesty, incompetence, misconduct, mismanagement, or irregularity in the management of the affairs of the debtor, or to a cause of action available to the estate; and (B) transmit a copy or a summary of any such statement to any unsecured creditors' committee or equity security holders' committee, to any indenture trustee, and to such other entity as the court designates."[132]

The examiner's investigation and report may have an important effect on the direction of the case, as well as on the pursuit of claims for the benefit of creditors. For example, the examiner's reports in the chapter 11 cases of Lehman Brothers, Residential Capital, and Tribune Company assessed the merits of claims asserted by parties in the case, identified additional potential claims and causes of action, and provided parties in interest with substantial information concerning the debtor and its case that otherwise likely would have been undiscovered or unavailable.[133] Commentators summarize these benefits as follows:

> If equipped with a mandate of sufficiently broad scope, an examiner may promote efficiency by navigating among the frequent multiplicity of other investigations by government authorities, boards of directors, creditors, and shareholders. The examiner may play the lead role among the players in the bankruptcy case by conducting an expansive and timely investigation that will aid parties later in pursuing monetary recoveries and other remedies. In many respects, the examiner should preempt the bankruptcy field by vastly reducing the need for early and duplicative discovery efforts by separate creditors or committees.[134]

Notwithstanding the potential benefit to the estate, some observers argue that an examiner simply adds another layer of cost and delay to the process and that the debtor in possession or unsecured creditors' committee can serve the same function.[135] The primary response to this potential critique is that an examiner comes to the process with a special, independent, and neutral role, which no other party can claim. The principle

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[131] 11 U.S.C. § 1104(c).

[132] *Id.* § 1106(a)(4) (referred to in 11 U.S.C. § 1106(b)).

[133] *See* Report of Kenneth N. Klee, Examiner, *In re* Tribune Co., No. 08-13141 (July 26, 2010) [Docket Nos. 5130, 5131, 5132, 5133]; Report of Anton R. Valukas, Examiner, *In re* Lehman Bros. Holdings, Inc., No 08-13555 (Bankr. S.D.N.Y. Mar. 11, 2010) [Docket No. 7531]; Report of Arthur J. Gonzalez, Examiner, *In re* Residential Capital, LLC, No. 12-12020 (Bankr. S.D.N.Y. May 13, 2013) [Docket No. 3698]. (Kenneth N. Klee and Arthur J. Gonzalez are Commissioners.).

[134] Clifford J. White III & Walter W. Theus, Jr., *Chapter 11 Trustees and Examiners after BAPCPA*, 80 Am. Bankr. L.J. 289, 290 (2006).

[135] *See, e.g.*, Dickerson, *supra* note 19, at 904 ("[H]aving an examiner in a case can substantially increase the costs of the reorganization and, accordingly, reduce the amount available to pay creditor claims. Because examiners are often appointed in cases that have active creditor committees, courts have refused to appoint an examiner if doing so would increase the number of fiduciaries already involved in a case. Some courts have argued that examiners often duplicate the work already being performed by creditors' committees.").

that the proper role of an examiner is that of a disinterested, nonadversarial officer of the court has been so widely accepted that it can hardly be doubted.[136]

Accordingly, the examiner provides an independent assessment of the matter at hand and can identify value, encourage parties to recognize the strengths and weaknesses of their respective positions in the case, facilitate quicker resolutions of disputes, and ultimately produce benefits for the estate. Nevertheless, one criticism of the process is that the examiner's report, which may identify this value and was paid for by the estate, may not be admissible as evidence in prosecuting or defending the causes of action investigated in the report.

Under current law, the role of an examiner is limited to the investigatory function described above. Yet examiners may add value to cases in other capacities given their uniquely independent and neutral posture. For example, courts have appointed mediators and facilitators to help chapter 11 cases progress, either when plan negotiations are stalled or major litigation threatens to derail reorganization efforts.[137] Such mediators and facilitators have proven effective in some cases, but they currently are appointed on an *ad hoc* basis and with little governing authority. Expanding the potential scope of an examiner to include the role of mediator and facilitator as well as similar functions would allow parties in interest and the court to use an independent neutral party to address specific issues in a particular case in an efficient and controlled manner. Many courts interpret section 1104 as currently prohibiting this kind of appointment, whether termed an "examiner" with expanded powers or a "trustee" with limited powers.[138]

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[136] Examples of cases stating this principle: Kovalesky v. Carpenter, 1997 WL 630144, at *3 (S.D.N.Y. Oct. 9, 1997) ("Examiners . . . play a chiefly information-seeking role and, like the court itself, must remain a neutral party in the bankruptcy process."); *In re* Big Rivers Elec. Corp., 213 B.R. 962, 977 (Bankr. W.D. Ky. 1997) ("[The examiner is] a party who is not an adversary but rather an independent third party and officer of the Court."); *In re* Interco Inc., 127 B.R. 633, 638 (Bankr. E.D. Mo. 1991) ("[T] he Examiner's role is by its nature disinterested and nonadversarial. There is no doubt that the Examiner is a neutral party in a bankruptcy case."); In re Baldwin United Corp., 46 B.R. 314, 316 (Bankr. S.D. Ohio 1985) ([The Examiner] is first and foremost disinterested and nonadversarial. . . . [H]e answers solely to the Court.").

[137] Examples of cases using court-appointed mediators: *In re* R.H. Macy & Co., Inc. 1994 WL 482948 (Bankr. S.D.N.Y. Feb. 23, 1994); *In re* Lehman Bros., Inc., Ch. 11 Case No. 08-13555 (JMP) (Bankr. S.D.NY.) (Jan. 16, 2009) [Docket No. 2569]. *See also* Cassandra G. Mott, *Macy's Miracle on 34th Street: Employing Mediation to Develop the Reorganization Plan in a Mega-Chapter 11 Case*, 14 Ohio St. J. on Disp. Resol. 193, 207–10 (1998); Harvey R. Miller, *The Changing Face of Chapter 11: A Reemergence of the Bankruptcy Judge as Producer, Director, and Sometimes Star of the Reorganization Passion Play*, 69 Am. Bankr. L.J. 431, 437 (1995). For an example of a court-approved arbitration procedure in the context of claims resolutions, *see* Meyer v. Dalkon Shield Claimants Trust, 164 F.3d 623, at *1 (4th Cir. 1998) (unpublished table decision) (explaining alternative dispute resolution procedures used to address products liability claims).

[138] *See, e.g.*, Official Comm. of Asbestos Pers. Injury Claimants v. Sealed Air Corp. (*In re* W.R. Grace & Co.), 285 B.R. 148, 156–57 (Bankr. D. Del. 2002) (denying debtor's motion to appoint examiner with expanded powers or trustee with limited purpose to prosecute fraudulent transfer claims because "the basic job of an examiner is to examine, not to act as a protagonist in the proceedings" and "[t]here is no such entity as a limited purpose trustee under the [Bankruptcy] Code"); Kovalesky v. Carpenter, 1997 WL 630144, at *3 (S.D.N.Y. Oct. 9, 1997) ("Examiners . . . play a chiefly information-seeking role and, like the court itself, must remain a neutral party in the bankruptcy process."); *In re* Interco Inc., 127 B.R. 633, 638 (Bankr. E.D. Mo. 1991) ("[T]he examiner's role is by its nature disinterested and non-adversarial. There is no doubt that the examiner is a neutral party in a bankruptcy case."); *In re* Baldwin United Corp., 46 B.R. 314, 316–17 (Bankr. S.D. Ohio 1985) ("[W]e never contemplated, nor in our opinion does the Bankruptcy Code contemplate, that the examiner act as a conduit of information to fuel the litigation fires of third-party litigants."); *In re* Hamiel & Sons Inc., 20 B.R. 830, 832 (Bankr. S.D. Ohio 1982) (an examiner "constitutes a court fiduciary and is amenable to no other purpose or interested party"). *But see* S. Rep. No. 989, 95th Cong. 2d Sess. 116 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787 ("The [bankruptcy] court is

b. The Estate Neutral: Recommendations and Findings

The Commission reviewed the case law and academic literature concerning the frequency and use of examiner appointments and the interpretation of the current statute, which mandates the appointment of an examiner in certain circumstances. The Commissioners explored, in the alternative, the utility of a new estate neutral, particularly in cases when, for example, stakeholders found value in leaving the debtor in possession in control, but certain matters in the case needed an independent assessment either because it was difficult for a debtor to investigate itself or because the debtor and stakeholders were too vested in their respective positions to identify areas of potential compromise. As further explained below, the Commission determined that the concept of an estate neutral should replace examiners under the Bankruptcy Code.

The Commissioners found little correlation between the standards for a mandatory appointment and the utility of the appointee in any given case, based on experiences with examiners under section 1104(c) of the Bankruptcy Code. Accordingly, the Commission voted to eliminate the mandatory nature of the appointment process and to permit the court to order the appointment of an estate neutral, upon request of a party in interest or the U.S. Trustee and after notice and a hearing, if such appointment would be in the best interests of the estate. The Commission specifically considered the existing case law, and it rejected a standard that required all interests to be served by the appointment. It found that, given the role contemplated for estate neutrals under these principles, the appointment standard should be flexible and tailored by the court to the particular case. Courts should determine if, on balance, the best interests of the estate would be served by the appointment.

The Commissioners further discussed the proper role of estate neutrals in the reorganization process. Absent the appointment of a trustee, all parties in the chapter 11 case have potentially diverging interests and may be motivated purely by self-interest. For example, the debtor in possession acts as a fiduciary for the estate, but the estate itself likely has different constituencies. The debtor in possession is also working to reorganize its business and preserve relationships with employees, vendors, and other constituents that ultimately serve the interests of the estate. Likewise, a statutory unsecured creditors' committee owes its duties to general unsecured creditors, but those creditors are not the only stakeholders in the case. The Commissioners observed that an estate neutral-like appointee is the only party uniquely situated to provide an independent and neutral perspective in the case. The Commission also considered other potential rationales for expanding the role of the new estate neutral from that of a traditional examiner in chapter 11 cases, such as facilitating dispute resolution and reducing information asymmetries.

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authorized to give the examiner additional duties as circumstances warrant."); *In re* Mirant Corp., 2004 WL 2983945, at *2–3 (Bankr. N.D. Sept. 1, 2004) (examiner authorized to monitor and mediate plan negotiations); *In re* Pub. Serv. Co. of N.H., 99 B.R. 177 (Bankr. D.N.H. 1989) (examiner authorized to mediate negotiations related to chapter 11 plan); *In re* UNR Indus., Inc., 72 B.R. 789 (Bankr. N.D. Ill. 1987) (examiner appointed to negotiate chapter 11 plan and facilitate resolution of substantive differences).

The Commissioners recognized the costs associated with the appointment of an examiner under the current law, as well as the additional costs that might accompany the new estate neutral, which could be used more frequently and for a wider array of tasks. Not only would the estate compensate the estate neutral, but the estate also would compensate any professionals that the court authorizes the estate neutral to retain. The Commissioners explored ways to contain these costs, including through court-approved budgets and restrictions on the efforts by the debtor in possession and the unsecured creditors' committee that may be duplicative of those assigned to the estate neutral. The Commissioners believed that this kind of oversight by the court and other stakeholders could mitigate the potential increases in costs. The Commissioners did not believe, however, that such restrictions should be statutorily mandated, but rather left to the court and parties in interest to determine in any given case.

The Commission also considered the potential cost savings that an estate neutral may generate in cases when the parties are at an impasse in negotiations or need an independent investigation to facilitate resolution of particular matters. The Commissioners discussed how courts should balance the costs associated with an estate neutral with the potential efficiencies created by the appointment. The Commissioners also observed that, even under this cost-benefit analysis, the circumstances of the case could warrant the appointment of more than one estate neutral to perform different functions in the case, but the Commissioners believed that this should be the exception rather than the rule. The Commissioners did not want to create roles for third parties in the case or impose additional costs on the process if unnecessary or if the benefits would be marginal at best. Accordingly, the Commission recommended a presumption against the appointment of more than one estate neutral in any given case, which could be rebutted by evidence that the circumstances of the case and a cost-benefit analysis support the additional appointment. The Commission also concluded that, with the elimination of the mandatory appointment provision, if the circumstances of the case warrant the appointment of an estate neutral, the potential benefit of the estate neutral to the estate would likely outweigh any additional costs to the estate. The Commission ultimately voted to provide more flexibility to the court and the parties in using estate neutrals, as set forth in the principles above, and to recommend use of estate neutrals in lieu of examiners.

The Commissioners discussed the related concept of a statutory reorganization executive, which would be similar in some ways to an examiner with expanded powers but different in several key respects. For example, a statutory reorganization executive would likely be suggested and supported by the debtor and could operate the debtor's business, work directly with the parties to help facilitate a plan, and function more as an insider of the debtor (akin to a chief restructuring officer).[139] The Commissioners explored the contours of this new fiduciary, which some Commissioners believed would need to be accountable to the debtor's board of directors and subject to applicable state fiduciary duty laws. The Commissioners who supported the concept of a statutory

[139] The Commissioners distinguished a chief restructuring officer from the proposed statutory reorganization executive, as the chief restructuring officer typically is retained as an officer of the company under applicable state law, subject to the same duties and obligations as the debtor's other officers. The Commissioners found the current process for engaging chief restructuring officers in appropriate cases sufficient and not inconsistent with the Commission's position on either the estate neutral or the restructuring officer.

reorganization executive viewed it as a private solution that parties would use more readily than seeking the appointment of a trustee or examiner. The Commissioners who opposed the concept of a statutory reorganization executive voiced concerns similar to those noted above respecting an examiner with expanded powers and viewed the appointment of a trustee as the better alternative. Ultimately, the Commission voted against the concept of a statutorily recognized reorganization executive, but did consider the potential value of such a position in considering and developing the parameters of the role of an estate neutral.

4. Statutory Committees

Recommended Principles:

- Except as provided in the principles for small and medium-sized enterprise cases, the appointment of an unsecured creditors' committee should remain mandatory as provided under section 1102(a) of the Bankruptcy Code unless the court orders otherwise for cause. The term "cause" should include that such an appointment would not be in the best interests of the estate or that the interests of general unsecured creditors do not need representation in the particular case because, for example, they will not receive any distributions in the case or their claims will be paid in full.
- The court sua sponte, the U.S. Trustee, or a party in interest should be able to initiate a hearing to determine whether the appointment or continuation of an unsecured creditors' committee would be in the best interests of the estate.
- The U.S. Trustee should continue to retain discretion to appoint a committee of equity security holders, more than one committee of unsecured creditors, or a single statutory committee for multiple affiliated debtors. Accordingly, no change to existing law is suggested on this point.

a. Statutory Committees: Background

The concept of a committee of creditors formed to monitor the debtor and its reorganization efforts stems from the equity receiverships of the late 1800s and Chapter XI of the Bankruptcy Act.[140] The unsecured creditors' committees that were formed in the equity receivership context were criticized for their close and arguably collusive relationships with the debtor.[141] Nevertheless, Congress recognized the value in the

[140] In an equity receivership, "creditors would petition the court for the receivership and form a protective or reorganization committee. In most cases, the reorganization committee, working with management, would be the successful bidder at the receivership sale." Michelle M. Harner & Jamie Marincic, *Committee Capture? An Empirical Analysis of the Role of Creditors' Committees in Business Reorganizations*, 64 Vand. L. Rev. 749, 758–760 nn.46–59 (2011) (explaining history of creditors' committees in bankruptcy and providing citations to additional resources). "Chapter XI charges creditors' committees with overseeing the conduct of the debtor and negotiating the debtor's plan of reorganization; for the most part, they were active participants in cases." *Id.* at 760.

[141] Justice Douglas observed: "In the welter of conflicting interests, ulterior objectives, and self-serving actions which flow from investment banker-management dominance over committees, these committees have lost sight of their essential functions which they can perform to advance the interests of investors." *To Amend the Securities Act of 1933: Hearing on H.R. 6968 Before the H. Interstate and Foreign Commerce Comm'n.*, 75th Cong. 24 (1937) (statement of William O. Douglas).

committee structure, both in terms of their oversight functions and the dynamic tension that their presence and participation adds to restructuring negotiations.[142] Congress thus maintained some form of committees in the Bankruptcy Act and extended that structure to all business reorganizations under chapter 11 of the Bankruptcy Code.

Section 1102 of the Bankruptcy Code provides that "the United States trustee shall appoint a committee of creditors holding unsecured claims"[143] that "shall ordinarily consist of the persons, willing to serve, that hold the seven largest claims against the debtor of the kinds represented on such committee. . . ."[144] The legislative history of section 1102 suggests that Congress intended to give unsecured creditors a stronger voice in the reorganization process.[145] The unsecured creditors' committee has been viewed not only as necessary to protect the interests of the many unsecured creditors unable to participate directly in the process, but also to further monitor the actions of the debtor in possession during the chapter 11 case. It can play "many roles" in a chapter 11 case.[146]

The appointment of a committee of unsecured creditors is mandatory in chapter 11 cases, but cases do proceed without committees in certain circumstances. For example, the U.S. Trustee can only constitute a committee if a sufficient number of creditors are willing to serve on the committee.[147] An individual creditor will often engage in a cost-benefit analysis to decide whether to serve on the unsecured creditors' committee. As a committee member, a creditor owes certain fiduciary duties, and its service consumes time and effort that could otherwise be devoted to the creditor's own business.

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[142] "The mandatory appointment of a creditors' committee was intended to provide dynamic tension with the debtor that would stimulate the reorganization process through effective and efficient oversight and negotiation." Miller, *supra* note 41, at 449. *See also* Michelle M. Harner & Jamie Marincic, *The Potential Value of Dynamic Tension in Restructuring Negotiations*, Am. Bankr. Inst. J., Feb. 2011, at 62–65; Thomas C. Given & Linda J. Philipps, *Equality in the Eye of the Beholder — Classification of Claims and Interests in Chapter 11 Reorganizations*, 43 Ohio St. L. J. 735, 735–36 (1982) (explaining "dynamic tension" in context of reorganization vs. liquidation restructuring options); Donald R. Korobkin, *Bankruptcy Law, Ritual and Performance*, 103 Colum. L. Rev. 2124, 2130 (2003) (explaining that results under bankruptcy laws often "spontaneously emerge . . . at a juncture of futility and loss, from the dynamic and generative tension of normative directives in unavoidable conflict").

[143] 11 U.S.C. § 1102(a)(1).

[144] *Id.* § 1102(b)(1).

[145] "This section [1102] provides for the appointment of creditors' and equity security holders' committees, which will be the primary negotiating bodies for the formulation of the plan of reorganization. They will represent the various classes of creditors and equity security holders from which they are selected. They will also provide supervision of the debtor in possession and of the trustee, and will protect their constituents' interests." H.R. Rep. No. 95–595, at 401 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6357.

[146] *In re* Haskell-Dawes, Inc., 188 B.R. 515, 521 (Bankr. E.D. Pa. 1995). "[T]he Bankruptcy Code authorizes such committees to, *inter alia*: consult with the trustee concerning the administration of the case; investigate the acts, conduct and financial condition of the debtor; investigate the operation of the debtor's business and the desirability of having such business continue; participate in the formulation of a plan; and provide advice to those whom the committee represents regarding any plan that is formulated." *Id.* at 519.

[147] Roberta A. DeAngelis & Nan Roberts Eitel, *Committee Formation and Reformation: Considerations and Best Practices*, Am. Bankr. Inst. J., Oct. 2011, at 20 n. 2 (noting that the U.S. Trustee "often cannot appoint a committee in other cases because an insufficient number of creditors are willing to serve"). *See* Harner & Marincic, *Committee Capture?*, *supra* note 140, at 777 (finding that in a study of chapter 11 cases filed between 2002 and 2008, 48.3 percent of cases involved at least one creditors' committee and 51.7 percent involved no creditors' committee). *See also In re* Aspen Limousine Serv., Inc., 187 B.R. 989, 994 n.6 (Bankr. D. Colo. 1995), *aff 'd as modified*, 198 B.R. 341 (D. Colo. 1996) ("[I]n practice, a committee is rarely appointed in a smaller case."); *In re* ABC Auto. Prods. Corp., 210 B.R. 437, 442–43 (Bankr. E.D. Pa. 1997) ("[A]s courts and commentators alike have noted, in many cases creditors' committees are inactive or ineffectual.").

Consequently, unsecured creditors may decide, particularly in smaller chapter 11 cases, that the economics do not favor service on a committee of unsecured creditors.

The U.S. Trustee must form (or try to form) a committee "as soon as practicable after the order for relief."[148] To meet this requirement, the U.S. Trustee, shortly after the petition date, actively solicits interest in committee service from the debtor's unsecured creditor body. "The size and exigencies of a case guide the solicitation and formation process."[149] The U.S. Trustee typically solicits the debtor's 20 largest unsecured creditors, but may expand its search to the top 30 if warranted by the case. Although many committee formation meetings are held in person, the U.S. Trustee also constitutes committees through telephone interviews, particularly in smaller cases.[150] "What does not vary, however, is the U.S. Trustee's need to gauge a creditor's genuine willingness to serve on the committee for legitimate reasons and the committee members' obligation to act as fiduciaries to the entire unsecured creditor constituency."[151]

The U.S. Trustee generally tries to appoint members to the committee who reflect the general unsecured claims pool in the particular case — e.g., bonds, trade, landlords, etc.[152] Section 1102 allows parties in interest to request, and the court to direct, a change in the composition of the unsecured creditors' committee or the appointment of additional committees.[153] The U.S. Trustee is the party, however, that implements the change in the composition of the unsecured creditors' committee or constitutes any additional committees. Moreover, section 1102 does not specifically address whether a single unsecured creditors' committee may represent the interests of unsecured creditors in multiple, jointly administered cases. The U.S. Trustee has used a single unsecured creditors' committee in such cases under certain circumstances, and courts have generally approved this approach.[154]

Once appointed, the unsecured creditors' committee serves in a fiduciary capacity with respect to the other unsecured creditors it represents and is granted certain powers under section 1103 of the Bankruptcy Code.[155] The committee may, among other

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[148] 11 U.S.C. § 1102(a)(1).

[149] DeAngelis & Eitel, *supra* note 147, at 20.

[150] *Id.*

[151] *Id.*

[152] *In re* Park W. Circle Realty, LLC, 2010 WL 3219531, at *2 n.6 (Bankr. S.D.N.Y. Aug. 11, 2010) ("Although committees do not necessarily need to reflect the precise composition of the creditor body, committees should adequately represent the various creditor types."); *accord In re* Hills Stores Co., 137 B.R. 4, 7 (Bankr. S.D.N.Y. 1992).

[153] 11 U.S.C. § 1102(a)(2), (4).

[154] *See, e.g., In re* Orfa Corp. of Phila., 121 B.R. 294, 299 (Bankr. E.D. Pa. 1990) (rejecting a *per se* rule regarding the appointment of a committee for each related debtor due to "the additional and unnecessary administrative costs that would result if another committee and a potential enclave of additional professionals [are] appointed"); *In re* McLean Indus, Inc., 70 B.R. 852, 862 (Bankr. S.D.N.Y. 1987) (noting the cost of separate committees "could be extreme"). *But see In re* White Motor Credit Corp., 18 B.R. 720, 722 (Bankr. N.D. Ohio 1980) ("As a matter of law, section 1102 indicates that each case should have a Court-appointed committee. While such language does not preclude the Court from appointing identical committees in related cases, it cannot be said to authorize a single committee under the circumstances of these proceedings."); *In re* Proof of the Pudding, Inc., 3 B.R. 645, 649 (Bankr. S.D.N.Y. 1980) (noting that "completely independent committees, devoid of overlapping membership, can better serve the interests of all of the other creditors in closely related cases").

[155] *See, e.g., In re* Fas Mart Convenience Stores, Inc., 265 B.R. 427, 432 (Bankr. E.D. Va. 2001) ("Members of the committee also have another duty — a fiduciary duty to all creditors represented by the committee."); *In re* Firstplus Fin., Inc., 254 B.R. 888, 894 (Bankr. N.D. Tex. 2000) ("In a Chapter 11 case, an Unsecured Creditors'

things, meet with the debtor, investigate the debtor's affairs, participate in the plan formulation process, and request the appointment of a trustee or examiner.[156] The committee may also retain professionals to represent it in the chapter 11 case.[157] The expenses of committee members and the fees and expenses of the committee's counsel and other professionals are generally paid from the estate.

b. Statutory Committees: Recommendations and Findings

The Commissioners had a robust discussion regarding the ongoing utility of unsecured creditors' committees in chapter 11 cases. Some Commissioners felt that the mandatory nature of a committee of unsecured creditors was no longer warranted given that the fulcrum claims are now secured claims in many debtors' capital structures. Thus, a committee may not be needed because (i) unsecured creditors anticipate being paid in full or (ii) the creditors it represents may be out of the money in many cases. These Commissioners proposed treating the appointment of all statutory committees as discretionary, the way in which the current law treats the appointment of equity security holders' committees.[158]

Other Commissioners believed that the oversight function served by the unsecured creditors' committee is critical to the process and should be preserved. The Commissioners noted the valuation challenge of determining early in a chapter 11 case that classes of debt are in the money or out of the money. For this reason alone, a *per se* rule based on the value of unsecured claims would be inadequate. The Commissioners also highlighted the role of the unsecured creditors' committee in creating value or critically analyzing the debtor's proposed reorganization plan to ensure that the enterprise value would not be artificially depressed or removed from the estate.

After extensive deliberation, the Commission recommended retaining the mandatory appointment of a committee of unsecured creditors in all cases, except small and medium-sized enterprise cases (addressed in a subsequent section).[159] The Commissioners found value in the traditional "watchdog" function of the committee, not only as a check on the debtor in possession, but also as a check on other stakeholders and the allocation of the estate's value among stakeholders. Indeed, unlike secured or administrative creditors — whose claims must be paid in order 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). The unsecured creditors' committee is the primary statutory protection for

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Committee is appointed by the Office of the United States Trustee and owes a fiduciary duty to act on behalf of all unsecured creditors.").

[156] 1 U.S.C. § 1103(c).

[157] *Id.* § 1103(a).

[158] *See, e.g., Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("In such cases, the statutory creditors' committee is not an equal negotiating partner of the debtor, since it represents creditors with a *de minimis* stake in the future company. In fact, the only avenue of recovery for unsecured creditors in such cases is typically litigation of sometimes dubious causes of action, which can cause the statutory committee to focus unduly on future litigation value. It therefore may not be appropriate for a statutory creditors' committee to be appointed in these cases; or, at least, limits should be placed on the committee's role.") (citations omitted).

[159] *See* Section VII, *Proposed Recommendations: Small and Medium-Sized Enterprise (SME) Cases*.

general unsecured creditors. Nevertheless, the Commission did find merit in the argument that a committee should not be appointed if its constituents have no need for representation in the case (i.e., their claims are out of the money or are being paid in full). The Commission agreed that this standard should be part of a "for cause" standard that would, if established by evidence at the hearing, allow the court to direct the U.S. Trustee not to appoint, or to disband, an unsecured creditors' committee.

The Commission agreed that the potential benefits of an active committee of unsecured creditors must be carefully balanced against the costs and potential delays associated with the various actions that such a committee could be entitled to take. For example, the Commissioners discussed the kinds of cases in which tactics by a committee can increase costs or delay the resolution of a case or a material transaction in the case. Although many of the Commissioners acknowledged the infrequency of such instances, they also recognized the potential harm to the estate and its constituents when they do occur. The Commission agreed, however, 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. On that point, the Commissioners also discussed cases in which a committee of unsecured creditors was ordered to share professionals with other committees (or even the debtor, provided appropriate protections were put in place) or in which a committee's professionals' fees and expenses were capped either overall or with respect to certain matters.[160]

Finally, the Commission considered the impact of potential conflicts of interests associated with the diverse membership of a typical committee of unsecured creditors. Specifically, the interests of one committee member may not align with those of other members or even with those of general unsecured creditors in a particular chapter 11 case.[161] For example, the interests of an unsecured creditor seeking to acquire equity in the reorganized debtor in exchange for its claims may not align with the interests of the debtor's trade creditors.[162] Also, committee members who hold equity in a competitor of

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[160] For a discussion of the costs and potential complications associated with multiple committees, *see* Kenneth N. Klee & K. John Shaffer, *Creditors' Committees Under Chapter 11 of the Bankruptcy Code*, 44 S.C. L. Rev. 995, 1024–25 (1993) ("[M]ultiple committees can complicate negotiations, delay the reorganization process, and create additional administrative expenses to the debtor's estate, particularly in terms of higher professional fees.").

[161] *See, e.g.*, Michael P. Richman & Jonathan E. Aberman, *Creditors' Committees Under the Microscope: Recent Developments Highlight Hazards of Self-Dealing*, Am. Bankr. Inst. J., Sept. 2007, at 22 (examining chapter 11 cases involving committee member conflicts of interest); Burke Gappmayer, *Protecting the Insolvent: How a Creditor's Committee Can Prevent Its Constituents from Misusing a Debtor's Nonpublic Information and Preserve Chapter 11 Reorganizations*, 2006 Utah L. Rev. 439, 445–46 (discussing conflicts of interest that may affect creditors' committee members); Carl A. Eklund & Lynn W. Roberts, *The Problem with Creditors' Committees in Chapter 11: How to Manage the Inherent Conflicts Without Loss of Function*, 5 Am. Bankr. Inst. L. Rev. 129, 130–33 (1997) (analyzing problems posed by committee member conflicts); Nancy B. Rapoport, *Turning and Turning in the Widening Gyre: The Problem of Potential Conflicts of Interest in Bankruptcy*, 26 Conn. L. Rev. 913, 916–17 (1994) (examining conflict of interest issues in bankruptcy, including in committee context).

[162] For example, section 1122(b) of the Bankruptcy Code permits a debtor use an administrative convenience class to pay trade creditors in full even when the plan is not able to fully repay claims of other unsecured creditors that will be discharged. *See* Brad B. Erens & Timothy W. Hoffmann, *The Triumph of the Trade Creditor in Chapter 11 Reorganizations*, J. Bankr. L., Jan. 2013, at 26 ("[D]ebtors sometimes have promulgated plans with very large administrative convenience claim caps for trade claims. Any claim up to that cap would be paid in full. Even claims above such cap could voluntarily elect to reduce their claims to the cap and, to that extent, often receive close to full payment. In this manner, debtors have been able to pay trade creditors under a plan a higher percentage on account of their claims then, for instance, similarly situated unsecured bondholders.").

the debtor may have adverse interests. The Commissioners acknowledged that the U.S. Trustee was asking more nuanced questions concerning a creditor's interests in a debtor's case during the committee formation process.[163] They recognized, however, that some conflicts of interest are inevitable. The Commission concluded that the court and the U.S. Trustee are both well positioned to address any problematic conflicts of interest that may arise on a committee on a case-by-case basis, in the same way in which they are empowered to address unnecessary costs and delays associated with unsecured creditors' committees.

5. Estate Fiduciaries

Recommended Principles:

- The doctrine set forth in *Barton v. Barbour*, 104 U.S. 126, 127–29 (1881) (which provides that to sue a court-appointed receiver, a party must obtain leave from the court that ordered such appointment) should also apply to the following parties in chapter 11 cases: trustees, estate neutrals, and statutory committees and their members, as well as professionals retained to represent any of the foregoing parties in their fiduciary capacity.

a. Estate Fiduciaries: Background

In *Barton v. Barbour*, the U.S. Supreme Court confirmed the "general rule that before suit is brought against a receiver leave of the court by which he was appointed must be obtained."[164] The Supreme Court also held that this general rule applies equally to suits seeking equitable relief (e.g., to recover specific property) and damages (i.e., money).[165] Courts have generally extended the *Barton* doctrine to trustees[166] in bankruptcy and other officers appointed by the court. "As the Sixth Circuit has observed, under the *Barton* doctrine, 'court appointed officers who represent the estate are the functional equivalent of a trustee.'"[167] Accordingly, some courts have determined that postconfirmation trustees and members of the unsecured creditors'

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[163] *See, e.g.*, DeAngelis & Eitel, *supra* note 147, at 58–59 (explaining that the U.S. Trustee considers, among other things, whether "the creditor will be paid as a critical vendor, has an executory contract or lease that will be assumed (and defaults cured), holds claims among multiple levels of the company's debt structure, or has insurance or other hedges that may limit its exposure or affect the identity of the true beneficial holder of the claim").

[164] Barton v. Barbour, 104 U.S. 126, 128 (1881).

[165] "A suit . . . brought without leave to recover judgment against a receiver for a money demand, is virtually a suit the purpose of which is, and effect of which may be, to take the property of the trust from his hands and apply it to the payment of the plaintiff 's claim, without regard to the rights of other creditors or the orders of the court which is administering the trust property." *Id.* at 129.

[166] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[167] *In re* Crown Vantage, Inc., 421 F.3d 963 (9th Cir. 2005) (quoting Allard v. Weitzman (*In re* DeLorean Motor Co.), 991 F.2d 1236 (6th Cir. 1993)).

committee are also deemed officers appointed by the court and thus covered by the *Barton* doctrine.[168]

The *Barton* doctrine is addressed, in part, by section 959(a) of title 28 of the U.S. Code, which provides that "[t]rustees, receivers or managers of any property, including debtors in possession, may be sued, without leave of the court appointing them, with respect to any of their acts or transactions in carrying on business connected with such property."[169] Courts have interpreted section 959(a) as an implicit limitation of the *Barton* doctrine and have acknowledged that litigation not covered by section 959(a) requires leave of court.[170] A litigant is thus required to seek leave of the court with respect to litigation against a chapter 11 trustee or other officer appointed by the court in connection with the liquidation or administration of a debtor's estate, except as provided in section 959(a). Moreover, some courts have extended the *Barton* doctrine to counsel for the trustee appointed by the court to the extent that such counsel was acting at the direction of the trustee for purposes of liquidating or administering the debtor's estate.[171]

b. Estate Fiduciaries: Recommendations and Findings

The Commissioners discussed the value of extending limited immunity to the chapter 11 trustee and similar fiduciaries for actions taken by them in their fiduciary capacity. In this context, the Commission reviewed the parameters of the *Barton* doctrine and its underlying policy justifications.

The Commission agreed that the *Barton* doctrine should be codified to clarify its scope and application to any trustee, estate neutral, and statutory committee and its members appointed in the chapter 11 case. The Commissioners found value in the following justification for such extension of the *Barton* doctrine:

> Just like an equity receiver, a trustee in bankruptcy is working in effect for the court that appointed or approved him, administering property that has come under the court's control by virtue of the Bankruptcy Code. If he is burdened with having to defend against suits by litigants disappointed by his actions on the court's behalf, his work for the court will be impeded.[172]

The Commissioners believed that this clarification would (i) allow any trustee, estate neutral, and statutory committee and its members to perform their fiduciary duties with confidence and focus,[173] and (ii) eliminate unnecessary litigation concerning the application of the *Barton* doctrine and whether the court in which a litigant files the

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[168] *Id. See also* Blixseth v. Brown, 470 B.R. 562 (D. Mont. 2012) (applying *Barton* doctrine to chair of the creditors' committee).

[169] 28 U.S.C. § 959(a).

[170] *See, e.g., In re* VistaCare Grp., LLC, 678 F.3d 218, 224–25 (3d Cir. 2012).

[171] McDaniel v. Blust, 668 F.3d 153 (4th Cir. 2012).

[172] *In re* Linton, 136 F.3d 544, 545 (7th Cir. 1998).

[173] *Id.* (explaining the importance of the *Barton* doctrine because without it, "[t]he threat of [the bankruptcy trustee] being distracted or intimidated is then very great"). "This concern is most acute when suit is brought against the trustee while the bankruptcy proceeding is still going on." *Id.*

action has subject matter jurisdiction over the dispute.[174] For similar reasons, the Commission voted to extend the *Barton* doctrine to any professionals retained by any trustee, estate neutral, or statutory committee or its members to the extent that the litigation involves the professionals' representation of such party in a fiduciary capacity.

The Commissioners recognized that this recommended principle could also apply to cases filed under other chapters of the Bankruptcy Code. Although the Commission did not study bankruptcy cases under these other chapters, it believed that the *Barton* doctrine should apply to all cases and proceedings under the Bankruptcy Code.

6. Valuation Information Packages

Recommended Principles:

- Except as provided in the principles for small and medium-sized enterprise cases, the debtor should compile a "valuation information package" ("VIP") containing the following information: (i) tax returns for the previous three years (inclusive of all schedules); (ii) annual financial statements (audited if available) for the prior three years (inclusive of all footnotes); (iii) most recent independent appraisals of any of the debtor's material assets (including any valuations of business enterprise or equity); and (iv) to the extent shared with pre-petition creditors and existing or potential purchasers, investors, or lenders, all business plans or projections prepared within the past two years.
- In connection with any motion filed under section 361, 362, 363, or 364 of the Bankruptcy Code or any chapter 11 plan filed within 60 days after the petition date or date of the order for relief, whichever is later, the debtor should file with the court a list of the information included in its VIP, unless the court orders otherwise for cause. A party in interest may request a copy of the VIP for a proper purpose, which includes the evaluation of the pending motion or proposed plan. Unless the court orders otherwise for cause, the debtor should provide a copy of the VIP promptly to any such requesting party, provided that the party executes a confidentiality agreement and, to the extent that the VIP contains material nonpublic information, agrees to restrict its trading activity in the debtor's claims, interests, and securities. The debtor should be able to redact or withhold information otherwise included in its VIP to the extent that the debtor determines in good faith that such redaction is necessary to prevent harm to the estate, unless the court orders otherwise.

a. Valuation Information Packages: Background

A debtor is required to file a variety of forms, schedules, and other information upon commencement of its chapter 11 case or shortly thereafter. The Bankruptcy Code generally gives debtors a short grace period after the petition date to file the required

[174] Courts generally hold that if the *Barton* doctrine applies and the litigant does not obtain leave of the bankruptcy court, other courts do not have subject matter jurisdiction over the matter. *See, e.g., In re* Crown Vantage, Inc., 421 F.3d 963, 971 (9th Cir. 2005).

forms,[175] and debtors typically can request additional time for the filing of certain materials.[176] Nevertheless, a debtor's timely and full disclosure is a necessary component of the chapter 11 process. Without this basic information, the court, the U.S. Trustee, and parties in interest cannot assess the debtor's reorganization efforts and make meaningful decisions in the case.

The debtor's financial information is perhaps among the most important of its disclosures. Under current law, a debtor is required to file some, but not necessarily the most relevant financial data early in the chapter 11 case, unless the court orders otherwise for cause. For example, every debtor that files periodic reports with the Securities and Exchange Commission must file "Exhibit A" along with its chapter 11 petition, which requires the debtor to list the value of its assets and the amount of its liabilities plus basic information regarding its capital structure (public and private debt and equity securities). Similarly, section 521(a) of the Bankruptcy Code and Rule 1007 of the Federal Rules of Bankruptcy Procedure (the "Bankruptcy Rules") require the debtor to file schedules of assets and liabilities and a statement of financial affairs, unless the court orders otherwise for cause. There is no specific requirement that such schedules and statements be prepared in accordance with generally accepted accounting principles ("GAAP"), and extensions of the deadline to file these documents are routinely requested and granted by courts. Separately, the U.S. Trustee requires a debtor to submit its financial information within one week of its petition date, as outlined in the applicable U.S. Trustee's Operating Guidelines and Reporting Requirements for Debtors in Possession and Chapter 11 Trustees, to facilitate the U.S. Trustee's oversight functions. The required information includes a list of bank accounts and insurance policies.[177] Finally, Bankruptcy Rule 2015 contains additional obligations to disclose financial information relating to inventory, receipts, disbursements, and other relevant matters.

Notably, none of these required disclosures provide the court, the U.S. Trustee, or parties in interest with financial data that could assist the parties in valuing the debtor's business or assets.[178] Such valuation information may be critically important early in the case when a debtor is seeking permission to use cash collateral, obtain debtor in possession financing, or sell some or all of its assets, and when creditors are seeking relief from stay.

b. Valuation Information Packages: Recommendations and Findings

The Commissioners analyzed the potential benefits of the requirement that debtors provide additional and earlier disclosures of meaningful financial data, particularly data that may assist parties in interest to assess valuation issues.[179] Among other potential

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[175] Fed. R. Bankr. P. 1007(c), (d).

[176] Fed. R. Bankr. P. 1007(a)(5) (permitting extensions of deadlines upon a showing of cause).

[177] The U.S. Trustee also has discretion to request additional information. In addition, the debtor must complete a monthly operating report for filing and submission to the U.S. Trustee.

[178] *See, e.g., Legislative Update: Valuation Issues a Key Topic at Chapter 11 Commission Hearing in Las Vegas*, Am. Bankr. Inst. J., Apr. 2013, at 125 (recommending earlier disclosures about debtor's business plan and business projections) (citing testimony by Eric Siegert of Houlihan Lokey).

[179] Some commentators have expressed dissatisfaction with the current lack of sufficient disclosures by the debtor early in the bankruptcy case. *See, e.g., id.* ("I'm generally frustrated with the notion of . . . confidentiality around a

benefits, such disclosures may help reduce information asymmetries and allow parties to make better-informed decisions regarding the impact of the debtor's proposed exit strategy on their recoveries in the case. Such disclosures could also facilitate more meaningful discussions regarding the debtor's viable reorganization options earlier in the chapter 11 case.

Based on the collective experiences of the Commissioners and recommendations from the advisory committee, the Commissioners identified various kinds of information that may be useful in making early valuation assessments. Such information includes the debtor's pre-petition tax returns, appraisals, and business plans, because these documents would contain information potentially relevant to valuation issues. Some of the Commissioners, however, voiced concerns about the required disclosure of such information, especially relating to the debtor's business plans. These Commissioners were specifically concerned that the requirement to disclose business plans, including restructuring strategies that would be available to any requesting creditor upon the commencement of the debtor's chapter 11 case, could result in a chilling effect on chapter 11 filings. The Commissioners therefore acknowledged the need to balance the benefits of additional and earlier disclosures with the likely confidentiality and strategic concerns of a potential chapter 11 debtor.

The Commissioners engaged in an in-depth discussion concerning the competing interests and potential value to the estate and stakeholders from additional and earlier disclosures. The Commission found that, on balance, additional and earlier disclosures by the debtor could assist in valuation determinations and should be required in certain specified circumstances. The Commission considered the advisory committee's recommendation that a debtor should be required to disclose pre-petition business plans only to the extent that the debtor shared such information with third parties prior to the petition date; requiring disclosure of this subset of information would prevent information asymmetries and ensure that all stakeholders would be similarly situated and on equal footing with respect to their information about the debtor's financial affairs. Conversely, proprietary information that a debtor elected to withhold from third parties before filing its chapter 11 petition would be protected from mandatory disclosure in the case.

To mitigate some of the valid concerns raised by the Commissioners regarding the debtor's confidentiality and strategy, the Commission agreed that the disclosure

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debtor's business plan early in the process. I understand that there are competitive secrets and things of that nature that need to be safeguarded, but at the end of the day when you look at a chapter 11 confirmation process, the business projections, almost without exception, are included in a disclosure statement, so they're made public anyway.") (citing testimony by Eric Siegert, Houlihan Lokey); *id.* at 126 ("Creditors' committees are frustrated by the amount of time [that] it takes for debtors to provide timely and thorough financial information. . . . As a result of this sluggish and time-consuming process of getting information, I believe that committees are often stymied in fulfilling their fiduciary obligations.") (citing testimony by Sandi Horwitz, CSC Trust Co.). Other commentators have suggested that the debtor's control of the flow of financial information, imprecise financial data, and the use of strategic valuation can have significant wealth consequences. *See, e.g.*, Stuart Gilson et al., *Valuation of Bankrupt Firms*, Rev. of Fin. Stud., Spring 2000, at 45–46 ("[S]enior claimants have incentives to underestimate cash flows to increase their recovery in Chapter 11 proceedings. The junior claimants, of course, have the opposite incentive: overestimating value increases their recovery. . . . [V] aluation errors are systematically related to proxies for the competing financial interests and relative bargaining strengths of the participants. . . . [V]aluations are used 'strategically' in a negotiation to promote a desired bargaining outcome.").

obligations should be subject to appropriate provisions regarding confidentiality and fiduciary outs. In addition, the debtor should be required to file only a list of the information included in its VIP if the trustee[180] or a party in interest requests certain relief under the Bankruptcy Code. A party in interest would then be able to request copies of such disclosure documents. Finally, the Commission concluded that the additional disclosure information should not be filed with the U.S. Trustee as a matter of course to alleviate a debtor's confidentiality concerns.[181] With these modifications, the Commission approved the recommended VIP as outlined in the principles above.

7. Professionals and Compensation Issues

Recommended Principles:

- The debtor's professionals should be clearly identified as either working on matters relating to the chapter 11 case ("chapter 11 professionals") or on matters unrelated to the chapter 11 case ("nonbankruptcy professionals").
- The Bankruptcy Code should define a "nonbankruptcy professional" as an individual or firm of lawyers, financial advisors, accountants, consultants, or other professionals retained by the debtor prior to or after the petition date working exclusively on business or legal matters that arise in, or relate primarily to, the day-to-day operations of the debtor's business and that could not have a material effect on the chapter 11 case.
- Only chapter 11 professionals should be subject to sections 327 and 330.
- The debtor should file with the court a list of its nonbankruptcy professionals with its chapter 11 petition and then subsequently on a quarterly basis. That filing should include the name of each professional and a general description of the work being performed by that professional. The court sua sponte, the U.S. Trustee, or a party in interest should be able to object to the classification of a professional as a nonbankruptcy professional. If the court, after notice and a hearing, sustains such objection, the professional should be subject to sections 327 and 330 only on a prospective basis. This principle does not obviate the trustee's need to otherwise comply with the U.S. Trustee's requirements for quarterly operating reports.
- To the extent professionals representing *ad hoc* committees, parties to any agreement or settlement, or secured creditors in the chapter 11 case would be paid their fees and expenses directly or indirectly (e.g., contractual provisions with junior creditors) from the estate under the Bankruptcy Code (either

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[180] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[181] The Freedom of Information Act generally applies to information in the possession of the U.S. Trustee. *See* Freedom of Information Act, http://www.justice.gov/ust/eo/foia/foia_request.htm. The U.S. Trustee's obligation to comply with FOIA likely would weaken any confidentiality restrictions and intensify a debtor's concerns regarding confidential and proprietary information. The Commission believed that the debtor and U.S. Trustee will be able to negotiate an acceptable protocol that provides the U.S. Trustee with sufficient information while protecting valid confidentiality and strategic concerns of the debtor.

through a substantial contribution motion, the creditors' proof of claim, the chapter 11 plan, or other order of the court), the approval and payment of their fees and expenses should be subject to the reasonableness standards set forth in section 330(a).

- Professionals retained by the debtor in possession or any statutory committee should not be considered fiduciaries of the estate. Rather, those professionals' duties should run to their respective clients and be governed by applicable nonbankruptcy law.
- A court should be permitted to authorize a trustee or an estate neutral to act not only as an attorney or an accountant for the estate, but also as a professional service provider for the estate to the extent that such authorization is in the best interests of the estate. The employment of a trustee or an estate neutral to act as a professional service provider should remain subject to appropriate limitations and restrictions to avoid self-dealing or other action that is improper or not in the best interests of the estate. Section 327(d) should be amended accordingly.

a. Professionals and Compensation Issues: Background

i. Nonbankruptcy Professionals

A debtor in possession[182] generally must seek court approval to retain professionals to assist it with the chapter 11 case. Specifically, section 327(a) of the Bankruptcy Code provides: "the trustee, with the court's approval, may employ one or more attorneys, accountants, appraisers, auctioneers, or other professional persons, that do not hold or represent an interest adverse to the estate, and that are disinterested persons, to represent or assist the trustee in carrying out the trustee's duties under this title."[183] The fees and expenses of professionals retained under section 327 are subject to court approval under section 330 of the Bankruptcy Code.[184]

The Bankruptcy Code does not define "professional persons" or specifically address the debtor in possession's ability to hire and pay professionals to assist with nonbankruptcy matters that arise in the operation of the debtor's business. The one exception to this statement involves lawyers retained for a special purpose. Section 327(e) provides: "The trustee, with the court's approval, may employ, for a specified special purpose, other than to represent the trustee in conducting the case, an attorney that has represented the debtor, if in the best interests of the estate, and if such attorney does not represent or hold any interest adverse to the debtor or to the estate with respect to the matter on which such attorney is to be employed."[185] In general, courts tend to

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[182] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[183] 11 U.S.C. § 327(a).

[184] *Id.* § 330. In addition, the U.S. Trustee has formulated guidelines for reviewing professionals' fees and expenses in the chapter 11 context. *See* Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses, 28 C.F.R. Part 58, Appendices A & B.

[185] 11 U.S.C. § 327(e).

define "professional" in one of two ways, focusing on whether the entity either (i) plays a central role in the administration of the estate, or (ii) is allowed to exercise judgment and autonomy in matters concerning the administration of the estate.[186] Accordingly, debtors in possession frequently seek clarification from the court concerning the scope of "professionals" retained by the debtor in possession and its ability to pay these professionals in the ordinary course of business.[187]

The disinterestedness standard generally requires that the professional not be a creditor or, within the two years before the petition date, a director, officer, or employee of the debtor. It also mandates that the professional not hold "an interest materially adverse to the interest of the estate or of any class of creditors or equity security holders, by reason of any direct or indirect relationship to, connection with, or interest in, the debtor."[188] Some courts interpret disinterestedness strictly, disqualifying any professional holding actual or potential conflicts of interest with the debtor.[189] Other courts take a more limited view and only disqualify the professional if it holds an interest that is "materially adverse" to the estate.[190]

Under the current law, debtors in possession will often seek court approval of procedures for retaining and compensating "ordinary course professionals" during the pendency of the chapter 11 case. These procedures typically require the debtor to identify the specific or general types of professionals or service providers covered by

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[186] *See, e.g.*, *In re* Am. Tissue, Inc., 331 B.R. 169, 173 (Bankr. D. Del. 2005) (using six-factor test to evaluate role of entity in case, including those above); *In re* Fretheim, 102 B.R. 298, 299 (D. Conn. 1989) (focusing on autonomy and judgment factors); *In re* Seatrain Lines, Inc., 13 B.R. 980, 981 (Bankr. S.D.N.Y. 1981) (focusing on role of entity in administration of estate). *But see In re* Metro. Hosp., 119 B.R. 910, 916 (Bankr. E.D. Pa. 1990) (defining professional as "someone with special knowledge and skill usually achieved through study and educational attainments whether licensed or not"). *See also In re* New Orleans Auction Galleries, Inc., 2013 WL 1196680 (Bankr. E.D. La. Mar. 25, 2013).

[187] A debtor in possession also may seek authority to pay service providers who are not characterized as professionals and who are retained outside the ordinary course of business under section 363(b) of the Bankruptcy Code. 11 U.S.C. § 327(a).

[188] *Id.* § 101(14)(E).

[189] *See, e.g.*, Dye v. Brown (*In re* AFI Holding, Inc.), 530 F.3d 832, 838 (9th Cir. 2008) ("[B]ankruptcy court did not abuse its discretion in concluding removal was proper due to the Trustee's past affiliations with insiders that created a potential for a materially adverse effect on the estate and an appearance of impropriety resulting in ongoing disharmony in the estate's administration."); *In re* Marvel Entm't Grp., Inc.,140 F.3d 463, 476 (3d Cir. 1998) ("(1) Section 327(a), as well as § 327(c), imposes a *per se* disqualification as trustee's counsel of any attorney who has an actual conflict of interest; (2) the district court may within its discretion — pursuant to § 327(a) and consistent with § 327(c) — disqualify an attorney who has a potential conflict of interest and (3) the district court may not disqualify an attorney on the appearance of conflict alone."); *In re* Martin, 817 F.2d 175, 182 (1st Cir. 1987) ("The question is not necessarily whether a conflict exists — although an actual conflict of any degree of seriousness will obviously present a towering obstacle — but whether a potential conflict, or the perception of one, renders the lawyer's interest materially adverse to the estate or the creditors.") (citation omitted); *In re* Lease-A-Fleet, Inc., 1992 U.S. Dist. LEXIS 407, at *2 (E.D. Pa. Jan. 15, 1992) ("I reject [the] argument that § 327(e) requires disqualification whenever there is a potential conflict. While some courts hold that simultaneous representation of the debtor and its guarantors is prohibited under § 327(e), such is clearly not the rule in this Circuit.") (citing *In re* G&H Steel Service, Inc., 76 B.R. 508, 510 (Bankr. E.D. Pa. 1987)).

[190] *See, e.g.*, Beal Bank, S.S.B. v. Waters Edge Ltd. P'ship, 248 B.R. 668, 695 (D. Mass. 2000) (quoting *In re* Martin, 817 F.2d 175, 182 (1st Cir. 1987)) ("[A]n inquiry does not have to ask 'whether a conflict exists . . . but whether a potential conflict, or the perception of one renders the lawyer's interest materially adverse to the estate or the creditors.'") (citations omitted); *In re* Leslie Fay Cos. Inc., 175 B.R. 525, 536 (Bankr. S.D.N.Y. 1994) ("[R]etention under section 327 is only limited by interests that are 'materially adverse . . . .'") (citations omitted). Notably, section 327(a) of the Bankruptcy Code refers to "an interest adverse to the estate" while section 101(14)(E) refers to "an interest materially adverse to the interest of the estate." 11 U.S.C. § 327(a).

the motion and to establish a cap that limits the amounts that can be paid to these entities (usually on a quarterly basis) during the case. Such ordinary course professionals may be required to file a verified statement under Bankruptcy Rule 2014(a), although debtors generally agree to submit quarterly summaries of the fees paid to these professionals. Courts routinely approve motions related to ordinary course professionals to enable a debtor to continue its operations during the chapter 11 case as efficiently as possible.

ii. Other Professionals

The ability of debtors in possession, trustees or other estate representatives, and statutory committees to retain professionals is subject to approval by the court under section 327 of the Bankruptcy Code; the court thereafter reviews and scrutinizes the compensation requests of professionals under section 330. Other parties in the chapter 11 case may also seek reimbursement for, or payment of, their professionals' fees and expenses from estate funds. These parties include secured creditors, creditors who are parties to an agreement or settlement with the debtor or the trustee, parties to intercreditor agreements, and *ad hoc* committees.[191] In some instances, such as with *ad hoc* committees, a party may seek payment for its professionals under section 503(b)(3)(D) of the Bankruptcy Code, which permits the payment of the reasonable fees and expenses of "a creditor, an indenture trustee, an equity security holder, or a committee representing creditors or equity security under chapter 9 or 11 of this title."[192] In other instances, the operative loan documents, intercreditor agreement, or other agreement may provide for such payment.

Courts generally require a party making a request under section 503(b)(3)(D) to prove "extraordinary efforts" to benefit the estate.[193] Some courts also require a showing that the party in fact intended to benefit the estate through such efforts.[194]

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[191] "A lock-up agreement — sometimes referred to as a plan-support agreement or restructuring-support agreement — often serves as an integral component of the bankruptcy process by allowing a debtor and its key creditors to memorialize the resolution of their legal and economic disputes and permit that debtor to attempt to confirm its plan and exit bankruptcy as expeditiously as possible." Kristopher M. Hansen et al., *Post-Petition Lock-Up Agreements and Designation Standards Clarified*, Am. Bankr. Inst. J., Apr. 2013, at 30. Ad hoc or unofficial committees play an important role in reorganization cases. By appearing as a 'committee' of shareholders, the members purport to speak for a group and implicitly ask the court and other parties to give their positions a degree of credibility appropriate to a unified group with large holdings. Moreover, the Bankruptcy Code specifically provides for the possibility of the grant of compensation to "a committee representing creditors or equity security holders other than a committee appointed under section 1102 of this title [an official committee], in making a substantial contribution in a case under chapter 9 or 11 of this title." *In re* Nw. Airlines Corp., 363 B.R. 701, 703 (Bankr. S.D.N.Y. 2007) (citing 11 U.S.C. § 503(b) (3)(D)).

[192] 11 U.S.C. § 503(b)(3)(D).

[193] *See, e.g., In re* Granite Partners, L.P., 213 B.R. 440, 445 (Bankr. S.D.N.Y. 1997) ("[C]ompensation is limited to those extraordinary actions . . . that lead to an 'actual and demonstrable benefit to the debtor's estate, the creditors, and to the extent relevant, the stockholders.'") (citations omitted); *In re* White Motor Credit Corp., 50 B.R. 885, 892 (Bankr. N.D. Ohio 1985) ("'Extraordinary efforts and remarkable results' are required for consideration of a premium payment.").

[194] *See, e.g., In re* Lister, 846 F.2d 55, 57 (10th Cir. 1988) ("Administrative expenses incurred prior to the filing of a bankruptcy petition are compensable under 11 U.S.C. § 503(b)(3)(D), if those expenses are incurred in efforts which were intended to benefit, and which did directly benefit, the bankruptcy estate."); *In re* Alert Holdings Inc., 157 B.R. 753, 758 (Bankr. S.D.N.Y. 1993) (court held that "[n]either [the creditor's] asserted help in forming the *ad hoc* committee, nor his participation in the multidistrict litigation demonstrates an intent to substantially benefit the

Moreover, if a party establishes a substantial contribution claim under section 503(b)(3)(D), it may also be entitled to reasonable compensation "for professional services rendered by an attorney or an accountant of an entity whose expense is allowable under subparagraph (A), (B), (C), (D), or (E) of paragraph (3) of this subsection, based on the time, the nature, the extent, and the value of such services, and the cost of comparable services other than in a case under this title, and reimbursement for actual, necessary expenses incurred by such attorney or accountant."[195]

iii. Trustee and Estate Neutral Issues

As suggested above, section 327 generally permits the trustee to retain lawyers, accountants, financial consultants, and other professionals to represent the estate and assist with the administration of the estate and the debtor's reorganization. These professionals must be disinterested and may not hold interests adverse to the estate.[196] Section 327(d), in turn, "permits the court to authorize the trustee, if qualified to act as his own counsel or accountant."[197] Notably, section 327(d) is limited to the trustee and to the trustee (or its firm) acting as lawyer or accountant. This provision does not account for other professionals who may serve as trustees and who could add value to the estate by representing the estate in their professional capacities.

In addition, a chapter 11 trustee is subject to the same compensation provisions applicable to chapter 7 trustees under sections 326(a) and 330. In a chapter 7 liquidation, the mechanics of section 326(a) work well[198]; a trustee is compensated based on a percentage of the moneys distributed to parties in interest other than the debtor. In a chapter 11 case, however, the limitations of section 326(a) might serve as a disincentive for a trustee to seek recoveries that would result in a return of funds to equity. In fact, some courts have denied compensation to chapter 11 trustees under section 326(a) when distributions are made to the debtor, or property or value other than money is distributed in the case.[199]

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debtors' estates, and any benefit that may have otherwise enured to the estates can be considered unintentional and incidental."); *In re* 9085 E. Mineral Office Bldg., Ltd., 119 B.R. 246, 251–52 (Bankr. D. Colo. 1990) ("[T]his Court cannot find that [the creditor's] efforts were in no way intended to confer a benefit upon the estate as a whole.").

[195] 11 U.S.C. § 503(b)(4).

[196] 11 U.S.C. § 327(a).

[197] S. Rep. 95-989, 38 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5824. *See also* 11 U.S.C. § 327(d).

[198] *See, e.g.*, Pritchard v. U.S. Trustee, 153 F.3d 232 (5th Cir. 1998) ("The section is consistent with the duty of a Chapter 7 trustee to collect and reduce the property of the bankrupt's estate to money.").

[199] *See, e.g.*, *id.* at 237 (declining to follow "bankruptcy courts [that] have interpreted the section to include disbursements other than money within the calculation of a trustee's maximum compensation") (collecting cases). In addition, some courts hold that a credit bid by a secured creditor is not moneys for purposes of section 326(a). *See, e.g., In re* Lan Assocs. XI, L.P., 192 F.3d 109, 116 (3d Cir. 1999); U.S. Trustee v. Tamm (*In re* Hokulani Square, Inc.), 460 B.R. 763, 777–78 (B.A.P. 9th Cir. 2011).

b. Professionals and Compensation Issues: Recommendations and Findings

i. Nonbankruptcy Professionals

Many professionals employed by a debtor in possession during the course of a chapter 11 case do not consult or work on bankruptcy-related issues. Rather, these professionals perform services that the debtor would have required outside the bankruptcy context and even if the chapter 11 case had not been filed. For example, the debtor may employ lawyers, forensic accountants, tax accountants, and other service providers to help with ordinary course business matters such as patent applications, regulatory compliance, or litigation relating to employee claims or disputes that are not material to the chapter 11 case. The Commission referred to these types of professionals as "nonbankruptcy professionals."

The Commissioners debated the utility of subjecting nonbankruptcy professionals to the retention standards in section 327(a) and the disclosure and reasonableness standards for professionals' fees and expenses in section 330 of the Bankruptcy Code. The Commissioners discussed the purpose underlying the retention standards of section 327(a). In the case of professionals working on bankruptcy matters that directly impact the estate, the relationships between the professionals and the debtor, creditors, and other stakeholders in the case are material and speak to potential conflicts that could bias the advice and actions of the professionals. Conversely, nonbankruptcy professionals generally do not work on matters that affect the rights of creditors and other stakeholders in the debtor's estate and do not address the claims of these parties or the allocation of the estate's assets. The debtor also would have likely retained these nonbankruptcy professionals even if it had not filed the chapter 11 case; the retention would have been governed by state law, including state ethical codes for lawyers that address conflicts of interest and fee arrangements. Consequently, the Commission agreed that nonbankruptcy state laws governing many professions are sufficient to protect the interests of the estate with respect to nonbankruptcy professionals.

The Commissioners, however, recognized that the work of nonbankruptcy professionals can impact the value of an asset of the estate or the debtor. The advice of nonbankruptcy professionals concerning a certain product or their assessment or management of a particular piece of litigation could underlie a substantial gain or loss by the debtor. The Commissioners discussed examples of nonbankruptcy litigation that could have a material effect on the chapter 11 case. They weighed the costs and benefits of setting a materiality threshold or compensation cap, and whether either such limitation would capture the significant matters with which they were concerned. On balance, the Commission agreed that requiring disclosure of the name of each nonbankruptcy professional and the nature of the services provided by such professional would provide the court, the U.S. Trustee, and parties in interest with sufficient information (and perhaps more meaningful information than that provided by a compensation cap) to determine if the professional should be reclassified as a chapter 11 professional subject to the requirements of sections 327, 328, and 330, even though the professional is not rendering bankruptcy-related services. In addition, the Commission determined that, with respect to professional firms, this classification should be made based on the firm as a whole, not based on the individual professionals

in such firm (i.e., if a law firm or financial firm is providing bankruptcy-related services in a debtor's chapter 11 case, the firm's status is imputed to all professionals, such that all professionals within that firm should be considered chapter 11 professionals).

The Commission also considered whether the reasonableness standards of section 330 should apply to the compensation requests of all professionals. Section 330 sets forth a variety of factors that the court should consider in reviewing and approving professionals' fees and expenses. The court's review requires meaningful disclosures from the professionals concerning their fees and expenses. Each professional retained by the debtor, unsecured creditors' committee, and any estate neutral or trustee (collectively, the chapter 11 professionals) is required to file detailed fee applications with the court to facilitate this review. The Commissioners believed that the disclosure and transparency demanded by section 330 was warranted when the professionals' services directly affected, assisted, or were performed on behalf of the estate and when the requested compensation would be paid by the estate. In these instances, the court, the U.S. Trustee, and parties in interest should have an opportunity to review the specific services performed and whether they justified the use of estate resources.

After comparing the roles of chapter 11 professionals versus nonbankruptcy professionals, the Commission determined that only chapter 11 professionals should be subject to the retention and compensation standards of sections 327 and 330. The Commissioners did not believe that the types of services provided by, and the typical compensation paid to, nonbankruptcy professionals warrant the time and expense associated with compliance under sections 327 and 330. Moreover, they found that the disclosure about nonbankruptcy professionals and their services would adequately protect the interests of the estate and allow reclassification if necessary or appropriate. In reaching its conclusions, the Commission emphasized that nonbankruptcy professionals should include only those professionals who — on an individual or firm basis — work exclusively on matters unrelated to the chapter 11 case. If a professional firm retained by the estate to perform services relating to the chapter 11 case also provides services to the debtor on general litigation or employment matters, for example, that firm and the professionals working at that firm should be considered chapter 11 professionals.

ii. Other Professionals

The Commission reviewed similar issues and concerns with respect to professional compensation paid by the estate for services provided to secured creditors; creditors who are parties to settlements or agreements with the debtor, trustee, estate or other parties in the case (e.g., intercreditor agreements); and *ad hoc* committees. The Commissioners recognized that the services of these professionals could add value to a chapter 11 case. Moreover, the payment of the attendant professionals' fees and expenses is often part of the underlying bargain and is authorized by an order of the court in connection with a substantial contribution motion, a motion to approve the settlement or agreement under the Bankruptcy Code, the creditor's proof of claim, or the chapter 11 plan. Nevertheless, some of the Commissioners expressed concern that parties often stipulate to the reasonableness of professionals' fees and expenses, such

that they are no longer subject to any meaningful review by the court or other parties in interest.

The Commission considered whether these professionals' fees and expenses should be subject to a fee application process, but ultimately determined that for these professionals, on balance, the standard of review was more important than the form of disclosures. The Commission also agreed that, to the extent the court disallows any professionals' fees and expenses under this standard, the creditor or *ad hoc* committee should not be permitted to seek reimbursement for disallowed fees from other stakeholders in the case. The Commission found that any such reimbursement mechanism would undermine the utility of the reasonableness review in that it could indirectly effect the obligations of the estate to other creditors. In light of the foregoing, the Commission voted to require the review of any professional compensation requested by professionals retained to represent secured creditors, creditors who are parties to agreements or settlements approved by the court, and *ad hoc* committees under the reasonableness standard of section 330(a) of the Bankruptcy Code. The Commission also agreed that this principle should not otherwise affect the permissibility or authorization of such professionals' fees and expenses under the Bankruptcy Code and current law.

iii. Trustee and Estate Neutral Issues

The Commission considered the justifications for limiting the trustee's professional services to the estate to those provided by lawyers and accountants. Some Commissioners suggested that these particular professional services were identified in section 327(d) because they were the primary services provided to bankruptcy estates at the time section 327 was adopted. Since that time, individuals serving as trustees may have different expertise and professional capacities. This change, in part, reflects the evolution of bankruptcy cases and the bankruptcy profession. Although lawyers and accountants continue to play important roles in chapter 11 cases, management consultants, financial advisors, and other professional service providers also are actively involved in bankruptcy cases and can add value to the process.

The Commissioners discussed the potential benefits and cost savings to the estate by permitting a trustee (or its firm) to act as, for example, a management consultant to the estate in connection with operating the debtor's business and administering the case. Although the Commissioners appreciated the need to ensure thersat professionals representing the estate are disinterested and do not hold adverse interests to the estate, they did not perceive significant issues when appointed trustees seek to perform certain specified professional services for the estate. Moreover, many Commissioners believed that estate neutrals, whom the U.S. Trustee also would determine to be disinterested and qualified, should be able to seek the same authority to represent the estate in their professional capacities. Accordingly, the Commission recommended expanding section 327(d) to include trustees and estate neutrals and to add "professional service provider" to the list of authorized roles for the trustee or estate neutrals.

The Commissioners also discussed the compensation structure of section 326(a) and whether it provided proper incentives to trustees to maximize the value of the

estate. As explained above, section 326(a) compensates trustees based on a percentage of the amount of moneys distributed or turned over to parties in interest in the case other than the debtor. Some Commissioners suggested modifying section 326(a) to exclude only distributions to "chapter 7 debtors and individual chapter 11 debtors" from the compensation calculation, recognizing the different focus of case administration in chapter 11 cases involving business debtors. These Commissioners noted that the exclusion of distributions to the debtor from the compensation calculation could encourage trustees to administer the estate in a manner that restricts recoveries or liquidates assets for the benefit of parties in interest other than the debtor in order to maximize the trustee's compensation. Other Commissioners suggested that such conduct likely would be a violation of the trustee's fiduciary duties, which should be a sufficient deterrent of such conduct. The Commissioners debated these points, focusing on the alignment of section 326(a) with a trustee's fiduciary duties to better serve the estate. The Commission ultimately was not able to reach a consensus on the issue. Nevertheless, several Commissioners believed that certain modifications could add value to cases and eliminate ambiguities in the application of section 326 to chapter 11 business cases.[200]

8. Costs in Chapter 11 Cases

Recommended Principles:

- The Bankruptcy Code should be clarified to expressly permit professionals retained pursuant to section 327 or 1103 of the Bankruptcy Code to seek the court's approval, at the outset of the engagement or of a particular matter, of alternative fee arrangements in lieu of the traditional hourly billing model. Such alternative fee arrangements could include the following: fixed fees, flat fees, task-specific fees, and contingent fees. Courts should assess the reasonableness of, and the potential benefits to the estate from, a professional's proposed alternative fee arrangement at the time that the court is evaluating the professional's original retention application or at the outset of the matter or engagement that will be subject to the proposed alternative fee arrangement. The professional seeking an alternative fee arrangement should bear the burden of proving by a preponderance of the evidence that the arrangement is reasonable, has been thoroughly reviewed with the client, and is reasonably likely to be beneficial to the estate. Section 328 should be clarified to incorporate this approval standard.
- Once a court has approved an alternative fee arrangement, it should not alter the approved arrangement once the matter or engagement has terminated unless, in accordance with section 328 as it currently provides, the "terms and conditions [of the arrangement] prove to [be] improvident in light of developments not capable of being anticipated at the time of the fixing of such

[200] Such beneficial modifications to section 326(a) might include limiting the exclusionary language of that section to "chapter 7 debtors and individual chapter 11 debtors" (rather than "the debtor") and expanding the concept of disbursements to moneys, property, or other value disbursed or turned over to parties in interest.

terms and conditions." Courts should not review alternative fee arrangements under the lodestar method, which is applicable to the hourly billing model.

- Congress should amend sections 328 and 330 to clarify that alternative fee arrangements based in whole or in part on non-hourly billing models are permitted and subject to review solely under section 328, in accordance with the changes proposed in these principles.

a. Costs in Chapter 11 Cases: Background

A common critique of chapter 11 is that it is too expensive: distressed companies cannot afford to file for bankruptcy and engage in the process of reorganizing under the protections of the Bankruptcy Code.[201] Although commentators debate the accuracy of this statement, the perception persists that chapter 11 is cost-prohibitive for many distressed companies.

The chapter 11 process is not free. It introduces costs into a company's budget that do not exist outside the bankruptcy context.[202] The debtor in possession also must retain and compensate bankruptcy professionals to assist with its chapter 11 case.[203] Importantly, the debtor's estate is also responsible for paying the fees and expenses of bankruptcy professionals that are retained by any statutory committees, examiners, and trustees that are appointed in the debtor's chapter 11 case.[204]

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[201] One prominent bankruptcy attorney at a major law firm observed that "bankruptcy has become so expensive that, ironically, poor companies or businesses with no cash cannot afford to go through the procedure." Natalie Posgate & Mark Curriden, *American Airlines Insiders Provide Exclusive Behind-the-Scenes Recap of Historic Bankruptcy and Merger*, Texas Lawbook (2014), *available at* http://www.law.smu.edu/getmedia/7430e732-144d-4fbf-ba3a-3273d2be862b/American-Airlines-Insiders-Reprint. Another seasoned turnaround consultant opined that "the cost of bankruptcy has gotten so high — because of professional and other costs — that the ability to continue the company under current ownership has reached almost zero." Ian Mount, *Adviser to Businesses Laments Changes to Bankruptcy Law*, N.Y. Times (Feb. 29, 2012).

[202] For example, currently a company must submit a filing fee of $1,717.00 to the bankruptcy court along with its petition to commence a chapter 11 case. During the pendency of its chapter 11 case, a debtor in possession also must remit quarterly fees to the Office of the U.S. Trustee, which are calculated each quarter based on the amount the debtor disbursed during such quarter. These fees currently range from $325 (for disbursement of $0 to $14,999.99) up to $30,000 (for disbursements of $30,000,000 or more). Pursuant to 11 U.S.C. § 1930(b), the Judicial Conference prescribes filing fees in all cases under the Bankruptcy Code. The current schedule of fees effective as June 1, 2014 is available at http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyResources/BankruptcyFilingFees.aspx. Bankruptcy courts enforce these filing fees. *See, e.g.*, Fee Schedule, United States of Bankruptcy Court, District of Delaware (effective June 1, 2014), *available at* http://www.deb.uscourts.gov/fee-schedule; Fee Schedule, United States of Bankruptcy Court, Southern District of New York (effective June 1, 2014), *available at* http://www.nysb.uscourts.gov/sites/default/files/pdf/filingFees.pdf.

[203] The Administrative Office of the U.S. Courts on behalf of the Federal Judiciary advises that "[c]orporations and partnerships must have an attorney to file a bankruptcy case. While individuals can file a bankruptcy case without an attorney or 'pro se,' it is extremely difficult to do it successfully." *Filing for Bankruptcy Without an Attorney*, http://www.uscourts.gov/FederalCourts/Bankruptcy/BankruptcyResources/FilingBankruptcyWithoutAttorney.aspx.

[204] Bankruptcy Code section 330 provides for compensation of all professionals — not just professionals retained by the debtor — whose retention was approved by the court. Specifically, section 330(a) provides, in relevant part:

> [T]he court may award to a trustee, a consumer privacy ombudsman appointed under section 332, an examiner, an ombudsman appointed under section 333, or a professional person employed under section 327 or 1103 —

The estate's administrative outlay for professionals' fees is often the focal point of debates concerning the costs of chapter 11.[205] Headlines such as *Extra! Extra! Tribune Fees Top $150 Million*,[206] and *American Airlines Bankruptcy Advisors Seek $400 Million in Fees, Expenses*[207] catch the attention of policymakers and the public alike, but a look behind the numbers cited in these headlines may reveal a different story.[208] In fact, empirical studies show that the total amount in professionals' fees in a chapter 11 case is generally a modest percentage of the debtor's assets, revenues, and distributions to creditors.[209] But these studies do not change the perception — whether or not

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> (A) reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any paraprofessional person employed by any such person; and
>
> (B) reimbursement for actual, necessary expenses.

11 U.S.C. § 330(a). A 2007 comprehensive study of professionals' fees in bankruptcy revealed that "[c]ommittee professionals cost the estate about two-fifths of what the debtor's professionals cost." *Jesse Greenspan, Time Spent In Chapter 11 Doesn't Affect Costs: Study*, Law 360 (Dec. 7, 2007, 12:00 AM), http://www.law360.com/articles/41896/time-spent-in-chapter-11-doesn t-affect-costs-study.

[205] *But see* Lubben, *What We "Know" About Chapter 11 Cost is Wrong*, *supra* note 44, at 144 ("[T]oo much of the debate about chapter 11 costs rests on a false premise . . . that professional fees in bankruptcy represent nothing more than wealth transfers, taking value from creditors and giving it to bankruptcy professionals"). A recent study of professionals' fees found that "[i]n almost 35% of [chapter 11] cases, professionals received no payment whatsoever," and typically these cases were smaller and were often converted to chapter 7 or dismissed. Greenspan, *supra* note 204. Based on a 2008 study of professionals' fees, Professor Lubben concluded that factors like the size of the debtor, the number of professionals retained, and whether a committee is appointed, which are all proxies for the complexity of the case, have much more significant effects on costs, as compared to the time spent in chapter 11, and that professionals' fees in chapter 11 are subject to economies of scale, especially in larger cases. Stephen J. Lubben, *Corporate Reorganization & Professional Fees*, 82 Am. Bankr. L.J. 77, 79–80 (2008).

[206] Eric Morath, *Extra! Extra! Tribune Fees Top $150 Million*, Wall St. J. Blog (May 25, 2011, 3:54 PM), http://blogs.wsj.com/ bankruptcy/2011/05/25/extra-extra-tribune-fees-top-150-million/.

[207] Sara Randazzo, *American Airlines Bankruptcy Advisers Seek $400 Million for Fees, Expenses*, Wall St. J. (June 26, 2014, 4:20 PM), http://online.wsj.com/articles/american-airlines-bankruptcy-advisers-seek-400-million-for-fees-expenses-1403814038.

[208] It is noteworthy that the court-appointed fee examiner recommended that the bankruptcy court approve the fees and expenses for 47 professional firms in the *American Airlines* case in the amount of nearly $400 million, noting that these professionals engineered "perhaps the most efficient airline reorganization case on record." *Id.* (The fee examiner in the *American Airlines* case was Robert Keach, Co-Chair of the Commission. In addition, several other Commissioners were involved in the *American Airlines* case.) Indeed, the value created in the merger of American Airlines and US Airways as part of American Airlines' reorganization plan resulted in all of American Airlines' creditors receiving full value on their claims and American Airlines' shareholders receiving shares amounting to approximately 40 percent of the merged company — at a market cap that exceeded the stand-alone value of American Airlines at any prior point in its history. Scholars have not analyzed whether the cost of fee examiners exceeds their benefit to the estate.

[209] Professor Lubben's study revealed that across all bankruptcy cases, and even across large chapter 11 cases specifically, professionals' fees totaled 4.0 percent to 4.5 percent of the sum of the debtor's assets and debts. Lubben, *Corporate Reorganization & Professional Fees*, *supra* note 205, at 103. *See also* Greenspan, *supra* note 204. These results are consistent with earlier fee studies. Based on a 2004 study of large chapter 11 reorganization cases filed from 1980 through April 2003, Professors LoPucki and Doherty found that some of the largest debtor cases expended less than 3 percent of their total assets to pay for professionals' fees. Lynn M. LoPucki & Joseph W. Doherty, *The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases*, 1 J. Empirical Legal Stud. 111, 140 (2004) ("For a group of 48 firms with assets ranging from about $65 million to $7.5 billion, and averaging $881 million, we found that total fees and expenses were 1.4 percent of total assets reported in the court file at the beginning of the bankruptcy case, and that firms expended, on average, 2.2 percent of assets on professional fees (1.9 percent after the removal of a single outlier)."). Professors LoPucki and Doherty explained that economies of scale were at play in large chapter 11 cases, such that the larger the debtor, the lower the ratio of restructuring fees and expenses the debtor incurred relative to its assets. *Id.* at 126. Earlier, Professor Baird also observed that the direct costs of bankruptcy for large, publicly traded companies was relatively small, between 0.9 percent and 7.0 percent, and an average of 2.8 percent, of the book value of the assets before the filing of the

accurate — that every dollar an estate pays in chapter 11 costs is one less dollar available to pay creditors.[210] As pointed out by one professor who has studied professionals' fees extensively, this perception necessarily ignores the value that professionals add to the estate during the pendency of a chapter 11 case for the benefit of all parties in interest.[211]

The U.S. Trustee and some commentators have criticized not only the overall amount of professionals' fees, but also the hourly rates of bankruptcy professionals, particularly in large chapter 11 cases.[212] The Office of the U.S. Trustee, for example, has raised concerns about lawyers charging hourly rates of $1,000 or more in some of the larger chapter 11 cases.[213] These and other compensation concerns recently led the Office of the U.S. Trustee to propose and ultimately adopt fee guidelines specifically applicable to professionals in chapter 11 cases involving $50 million or more in assets or liabilities.[214]

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bankruptcy petition, which was comparable to or less than the costs of an initial public offering, private placement, or leveraged buyout. Douglas G. Baird, *The Hidden Virtues of Chapter 11: An Overview of the Law and Economics of Financially Distressed Firms*, Coase-Sandor Inst. for L. & Econ. Working Paper No. 43, 1997, at 11–12, *available at* http://chicagounbound.uchicago.edu/law_and_economics/527/.

[210] Under Bankruptcy Code section 503(b)(2), "compensation and reimbursement awarded under section 330(a) of [the Bankruptcy Code]" are classified as "administrative claims." 11 U.S.C. § 503(b)(2). Section 507, which sets forth the priority order for the payment of unsecured creditors, elevates the payment of "administrative expenses allowed under section 503(b)" above the payment of all other unsecured debts (except domestic support obligations). 11 U.S.C. § 507(a)(1). Therefore, in a chapter 11 case that cannot support full recoveries to all creditors, administrative claims reduce the amount of funds that will be available for distribution to unsecured creditors.

[211] "Being in chapter 11 means that creditors' recovery on their claims becomes higher than zero. The professional fees are the cost of moving to that higher recovery. The notion that money paid to professionals belongs to creditors is true only if the creditors could realize that value without the professionals." Lubben, *What We "Know" About Chapter 11 Cost is Wrong*, *supra* note 44, at 144. "The cost paid to chapter 11 professionals is an example of the old truism that sometimes you have to spend money to make money. In chapter 11, creditors have to spend some money to recover some of what is due to them. In the main, the value of chapter 11 professionals' time was never a value that creditors could capture. Pretending that fees paid to professionals represents a real loss to the creditors demonstrates little more than muddled thinking." *Id.* at 145.

[212] Nancy B. Rapoport, *Rethinking Professional Fees in Chapter 11 Cases*, 5 J. Bus. & Tech. L. 263, 270–71 & n.28 (2010), *available at* http://digitalcommons.law.umaryland.edu/jbtl/vol5/iss2/5 (summarizing published criticisms of professionals' fees in chapter 11 context).

[213] Jacqueline Palank, *$1,000/Hour Bankruptcies: Attorneys Justify Their Fees*, Wall St. J. (June 3, 2012, 6:29 PM) ("The Justice Department has grown increasingly restless with attorney fees — often exceeding $1,000 an hour — paid by companies going through a bankruptcy reorganization.").

[214] The new fee guidelines became effective for cases filed on or after November 1, 2013. Appendix B — Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed Under 11 U.S.C. § 330 by Attorneys in Larger Chapter 11 Cases, 78 Fed. Reg. 36,248, 36,249 (June 17, 2013), *available at* http://www.justice.gov/ust/eo/rules_regulations/guidelines/docs/ Fee_Guidelines.pdf [hereinafter *UST Fee Guidelines*]. "Generally, the final guidelines provide for a showing that rates charged reflect market rates outside of bankruptcy; the use of budgets and staffing plans; the disclosure of rate increases that occur during the representation; the submission of billing records in an open, searchable electronic format; and the use of fee examiners and 'efficiency' counsel." *Statement of Clifford J. White III, Director, Executive Office for United States Trustees, U.S. Department of Justice, before the Subcomm. on Regulatory Reform, Commercial and Antitrust Law of H. Comm. on the Judiciary*, at 10 (Sept. 19, 2014) [hereinafter *White Statement*]. For a one-page summary of the *UST Fee Guidelines* prepared by the U.S. Department of Justice, *see* Summary of Material Differences from 1996 Guidelines,
http://www.justice.gov/ust/eo/rules_regulations/guidelines/docs/One_Page_Summary_AppxB_Guidelines.pdf. *See also* Marina Fineman, *For Lawyers Only: New Fee Application Guidelines for Attorneys in Large Chapter 11 Cases*, ABI Ethics & Professional Compensation Committee News, Vol. 10, no. 4, *available at* http://www.abiworld.org/committees/newsletters/ethics-and-professional-compensation/vol10num4/lawyers.html.

The stated goals of the new fee guidelines are to, among other things, "ensure that bankruptcy professionals are subject to the same client-driven market forces, scrutiny, and accountability as professionals in nonbankruptcy engagements;" "increase disclosure and transparency in the billing practices of professionals seeking compensation from the estate;" and "increase public confidence in the integrity and soundness of the bankruptcy compensation process."[215] Notably, only a small number of chapter 11 cases fall within these new fee guidelines.[216]

Additionally, the increasing cost of chapter 11 has had a significant impact on the perceived ability — and perhaps actual ability — of small and middle-market companies seeking restructuring options to invoke chapter 11.[217] One commentator observed that, based on a small sampling of cases filed in 2010 in the Southern District of New York, "professional fees for the middle-market Chapter 11 cases typically approached or exceeded $1 million."[218] This commentator suggested that high professionals' fees, among other factors,[219] have encouraged lawyers representing middle-market companies to pursue alternatives to traditional chapter 11 reorganization, such as section 363 asset sales on an expedited basis, followed by a liquidating plan, or to invoke alternatives under state law, including general assignments for the benefit of creditors and composition agreements to restructure debt.[220] Although this particular

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[215] *UST Fee Guidelines*, *supra* note 214, at 36,251–36,254. *See also White Statement*, *supra* note 214, at 10 (explaining objectives underlying study of fees leading to new fee guidelines as including "(1) ensur[ing] that fee review is subject to client-driven market forces, accountability, and scrutiny; (2) enhance[ing] meaningful disclosure and transparency in billing practices; (3) decreas[ing] the administrative burden of review; (4) maintain[ing] the burden of proof on the fee proponent; and (5) increase[ing] public confidence in the integrity and soundness of the bankruptcy compensation process").

[216] The *UST Fee Guidelines* apply only to the so-called mega-chapter 11 cases, which are referred to as "larger chapter 11 cases." A "***larger chapter 11 case***" is defined as "a chapter 11 case with $50 million or more in assets and $50 million or more in liabilities, aggregated for jointly administered cases and excluding single asset real estate cases as defined in 11 U.S.C. § 101(51B)." *UST Fee Guidelines*, *supra* note 214, at 36,249. *See also* Fee Guidelines for Attorneys in Larger Chapter 11 Cases, http://www.justice.gov/ust/eo/rules_regulations/guidelines/; *White Statement*, *supra* note 214, at 10 ("To date, 61 cases have been filed to which the guidelines apply, and we are monitoring them closely.").

[217] With respect to small and middle-market companies, "if they have to go into Chapter 11, the odds of the owners keeping the business are much lower. So there's no incentive for the owners to enter Chapter 11 and reorganize. Why save a company for somebody else?" Mount, *supra* note 201.

[218] Jeffrey A. Wurst, *Is Chapter 11 Still a Viable Option or Has High Cost Rendered the Process Unaffordable?*, ABF J., Mar. 2013, at 57.

[219] "There are several reasons why traditional reorganizations have been sparse. Amongst them are: 1.) the high cost of professional fees; 2.) uncertainty as to the outcome; 3.) lack of availability of unencumbered assets that otherwise may be utilized to secure a DIP lending facility or to fund post-petition obligations under a plan of reorganization; and 4.) alternatives such as out-of-court restructurings and assignments for the benefit of creditors." *Id.* at 56.

[220] "Liquidating Chapter 11 cases, for better or worse, have been the rule and not the exception in this Court and others over the last decade, if not longer." *Id.* (quoting *In re* Applied Theory Corp., Case No. 02-11868 (Bankr. S.D.N.Y. Apr. 24, 2008) (Gerber, J.)). A study of approximately 60 chapter 11 cases filed in 2010 in the U.S. Bankruptcy Court for the Southern District of New York concluded that alternatives to chapter 11 proved to be more affordable for middle-market debtors. For example, although professionals' fees typically approached or exceeded $1 million for a chapter 11 reorganization, "sales of assets pursuant to § 363 of the Bankruptcy Code, coupled with a structured dismissal, resulted in significantly lower fees, especially in those cases where the sale was conducted very early in the proceedings." *Id.* at 57. "Out-of-court restructurings have become a more favorable alternative by streamlining the restructuring process allowing cost savings to be passed down to the creditor body." *Id.* Assignments for the benefit of creditors ("***ABCs***") as well as composition agreements to restructure debt have become low-cost alternatives to chapter 11 reorganization, and in some cases, even alternatives to section 363 sales. *Id.*

study was limited in size and geographic area, the commentator's findings mirror the testimony and anecdotal evidence presented to the Commission during its study process.[221]

b. Costs in Chapter 11 Cases: Recommendations and Findings

The costs associated with chapter 11 and the desires to make the chapter 11 process more efficient and cost-effective were among the central themes of the Commission's study. The Commission was mindful that improving the utility of chapter 11 would do little for distressed companies if the process was perceived to be — or was in fact — cost-prohibitive. The Commission was keenly aware that tackling this issue would require most Commissioners to ask hard questions about their own practices and those of their colleagues, who are not only bankruptcy professionals in chapter 11 cases, but who are also, in many instances, subject to the U.S. Trustee's new fee guidelines. Nevertheless, the Commission agreed that it could and would perform this task because it believed that addressing chapter 11 costs is necessary for effective chapter 11 reform.

The Commissioners discussed the various costs associated with filing a chapter 11 case and continuing to conduct business as a debtor in possession.[222] The Commission focused its inquiry on several factors that may contribute to the increasingly high cost of chapter 11. These factors included the prolonged duration[223] and complexity of a case leading to inefficiencies, the use of strategic or protective litigation in the case by the debtor or other stakeholders, the inherent uncertainty about the outcome of certain processes or legal standards that become the subject of litigation, and the professionals'

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[221] *See, e.g.*, John Haggerty, *Written Statement to the Commission* (Apr. 19, 2013) ("In the last ten years, there has been an increase in the use of out-of-court alternatives . . . because the process is too time consuming and complex, and as a result, too costly."), *available at* Commission website, *supra* note 55; The Honorable Dennis Dow, *Written Statement to the Commission* (Apr. 19, 2013) ("The process of preparing a disclosure statement, obtaining approval of that document, soliciting creditor votes and satisfying the numerous requirements to obtain confirmation of the plan takes time and money. Adding to the costs is the requirement that the Chapter 11 debtor pay the costs of professional fees incurred by other entities in the case, such as creditor's committees. Provisions offering accommodations for small business debtors have been in the Code for some time, but do not appear to have alleviated these problems."), *available at* Commission website, *supra* note 55; Daniel Dooley, *Statement to the Commission*, at 37 (Apr. 19, 2013) (ASM Transcript) ("It's really widely understood and agreed, I think, in the community right now, that Chapter 11 just isn't cost-effective in the middle market. It doesn't really provide an opportunity of companies to rehabilitate themselves. . . . So people believe and I think I'm in this category as well, that Chapter 11 and the middle market is simply too slow, and it's simply too costly for almost all the cases."), *available at* Commission website, *supra* note 55; Professor George Kuney, *Written Statement to the Commission* (Nov. 7, 2013) ("The number of middle-market and smaller businesses entering chapter 11 and emerging as viable enterprises is falling. Administrative costs for plans in middle-market and smaller cases are too high and as a result, debtors are increasingly relying on numerous alternatives to the traditional chapter 11 process."), *available at* Commission website, *supra* note 55.

[222] As suggested above, the filing fee is relatively modest and the quarterly fees owed to the U.S. Trustee are largely scaled to a debtor's business size, measured by the debtor's disbursements as reported in its debtor's monthly operating reports. Although these fees may be difficult for some debtors to pay, as a general matter neither fee is unduly burdensome, and the proceeds from these fees support the oversight and administration of the chapter 11 case.

[223] The general consensus of the Commissioners was that the duration of chapter 11 cases was perceived as a cost enhancer. Notably, this perception is refuted by Professor Lubben's studies. *See generally* Lubben, *Corporate Reorganization & Professional Fees*, *supra* note 205; Lubben, *What We "Know" About Chapter 11 Cost is Wrong*, *supra* note 44.

fees and expenses incurred in connection with the case.[224] The Commission considered various ways to mitigate each of these factors.

To improve the efficiency of, and certainty in, the process, the Commission strived to develop reform principles to achieve these objectives in different aspects of chapter 11. For example:

- The Commission identified, analyzed, and, wherever possible, recommended principles to resolve splits in the case law governing chapter 11 cases to reduce the need for litigation and provide greater certainty about outcomes. To this end, the Commission sought to resolve the following splits, among others:
  - The standard of review applicable to the appointment of a chapter 11 trustee under section 1104;[225]
  - The permissibility of cross-collateralization and roll-up provisions in post-petition financing facilities;[226]
  - The proper use of the doctrine of necessity in chapter 11 cases;[227]
  - The ability of drop shipment transactions to qualify for administrative claim treatment under section 503(b)(9);[228]
  - The interplay between the priority afforded to wage claims under section 507(a)(4) and the priority afforded to employee benefit plan claims under section 507(a)(5);[229]
  - The ability of a debtor to apply section 1114 to terminate retiree benefit plans that the debtor has the right to unilaterally terminate outside the bankruptcy context;[230]
  - The definition of "executory contract" for purposes of section 365;[231]
  - The effect of rejecting an executory contract or unexpired lease under section 365;[232] o The ability of a debtor to assume intellectual property licenses under section 365(c)
    (i.e., the hypothetical test versus the actual test)[233] and the treatment of trademark licenses generally;[234]

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[224] These conclusions are consistent with a comprehensive fee study conducted by Professor Lubben. *See* Lubben, *Corporate Reorganization & Professional Fees*, *supra* note 205. Professor Lubben found that "factors such as the retention of several additional professionals and the appointment of an unsecured creditors' committee are big factors that determine how much a chapter 11 reorganization ultimately costs. These factors are proxies for the size of the debtor and, more directly, the complexity of its reorganization." *Id.* at 80. "The complexity of the bankruptcy and the compensation structure for the professionals retained (which may itself reflect further aspects of complexity) are the key determinants of cost." Lubben, *What We "Know" About Chapter 11 Cost is Wrong*, *supra* note 205, at 147.

[225] *See* Section IV.A.2, *The Chapter 11 Trustee*.

[226] *See* Section IV.B.2, *Terms of Post-petition Financing*.

[227] *See* Section IV.D.1, *Prepetition Claims and the Doctrine of Necessity*.

[228] *See* Section V.E.1, *Section 503(b)(9) and Reclamation*.

[229] *See* Section IV.D.2, *Wage and Benefits Priorities*.

[230] *See* Section V.D.2, *Retiree Benefits and Section 1114*.

[231] *See* Section V.A.1, *Definition of Executory Contract*.

[232] *See* Section V.A.3, *Rejection of Executory Contracts and Unexpired Leases*.

[233] *See* Section V.A.4, *Intellectual Property Licenses*.

[234] *See* Section V.A.5, *Trademark Licenses*.

- The proper calculation of a landlord's claim against the estate (i.e., the accrual approach versus the billing date approach);[235]
- The application of the safe harbor in section 546(e) to bar fraudulent transfer actions brought under applicable nonbankruptcy law (i.e., state laws including the Uniform Fraudulent Transfer Act or similar statutes as adopted in each state);[236]
- The treatment of ordinary supply contracts as qualified financial contracts subject to the protection of the Bankruptcy Code's safe harbor provisions;[237]
- The meaning of "for the benefit of the estate" under section 550;[238]
- The fiduciary duties of a debtor (as opposed to a debtor in possession) proposing a chapter 11 plan;[239]
- The fiduciary duties of professionals paid from the estate;[240] and
- The permissibility of gifting[241] and nonconsensual third party releases[242] in the context of a chapter 11 plan.

• The requirement that a debtor identify and disclose information relevant to valuation issues earlier in the case should provide a more transparent and expedient chapter 11 process for all parties in interest.[243]

• The creation of an "estate neutral" offers the court, the debtor, and other parties in interest a tool to more cost-effectively investigate and resolve disputes and other potential barriers to a debtor's reorganization efforts.[244]

• The enhanced procedures governing a debtor's request to modify or terminate a collective bargaining agreement under section 1113 should encourage (i) the debtor to initiate this process earlier in the case and (ii) both the debtor and authorized representatives to undertake meaningful negotiations before moving forward with litigation strategies.[245]

• A clear set of rules governing a sale of all or substantially all of a debtor's assets in chapter 11 — with appropriate protections and adequate time to allow the court, the debtor's stakeholders, and potential bidders to identify and resolve issues relating to the debtor's proposed exit strategy — should reduce delay, diminish the risk of losing value for the estate, and should simplify and expedite procedures.[246]

• The ability of a debtor or plan proponent to cram down a chapter 11 plan without the need to have an accepting impaired class of claims should eliminate (i) manipulative, strategic, and tactical maneuvering by the debtor and creditors

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[235] *See* Section V.A.6, *Real Property Leases*.
[236] *See* Section IV.E.1, *Scope of Section 546(e) Safe Harbors*.
[237] *See* Section IV.E.3, *Assumption of Financial Contracts*.
[238] *See* Section V.C.2, *Recoveries Under Section 550*.
[239] *See* Section IV.A.5, *Estate Fiduciaries*.
[240] *See* Section IV.A.7, *Professionals and Compensation Issues*.
[241] *See* Section VI.C.6, *Class-Skipping and Intra-Class Discriminating Distributions*.
[242] *See* Section VI.E.3, *Third Party Releases*.
[243] *See* Section V.F, *General Valuation Standards*.
[244] *See* Section IV.A.3, *The Estate Neutral*.
[245] *See* Section V.D.1, *Collective Bargaining Agreements Under Section 1113*.
[246] *See* Section V.B, *Use, Sale, or Lease of Property of the Estate*.

> (e.g., class construction, acquiring blocking positions within classes, etc.), and (ii) litigation concerning classification and impairment issues and focus the confirmation process on the merits of the plan.[247]
>
> • Similarly, the refinement of the absolute priority rule to permit distributions to junior creditors when supported by the reorganization value and redemption option value in the case,[248] as well as the codification of the new value corollary,[249] should reduce litigation and expedite the confirmation process.
>
> • Specific guidelines tailored for small and medium-sized enterprises should streamline and simplify the chapter 11 process for these kinds of debtors and eliminate litigation and expense concerning the new value corollary, the absolute priority rule, and the section 1129(a)(10) issues that are prevalent in these cases.[250]

The Commission also discussed the increased costs imposed on the estate by professionals' fees and expenses in a chapter 11 case. In this context, the Commissioners reflected on the testimony of field hearing witnesses regarding the costs of chapter 11, including the following testimony by Wilbur Ross:

> The most persistent investor complaint about the Chapter 11 process is the level of professional fees. . . . I believe there are several reasons for the high level of fees. At the onset of a case and sometimes even well into it, it is difficult for the judge to decide how many constituencies may be out of the money. This can lead to a proliferation of committees . . . The second problem is that committees whose claims are at or near the cusp of worthlessness have every reason to delay the case in the hope that the Debtor's business may turnaround . . . The third problem is the individual large creditor or *ad hoc* group of such creditors who may or may not be on the official committee for that class but who in any event play a proactive individual role in the proceeding and ultimately seek reimbursement of professional fees based on the argument of "substantial contribution."[251]

The Commissioners engaged in an in-depth review of professionals' fees and expenses in chapter 11. The Commissioners started this process by discussing the history and evolution of professionals' fees in bankruptcy. The state of professionals' fees prior to the Bankruptcy Code can be summarized as follows:

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[247] *See* Section VI.F.1, *Class Acceptance Generally and for Cramdown Purposes*.
[248] *See* Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.
[249] *See* Section VI.C.2, *New Value Corollary*.
[250] *See* Section VII, *Proposed Recommendations: Small and Medium-Sized Enterprise (SME) Cases.*
[251] Wilbur Ross, *Written Statement to the Commission* (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

> Under the former Bankruptcy Act, the "economy of administration" standard prevailed. That standard required the courts to consider the public interest in conserving and administering the estate as efficiently as possible. Many concluded that this standard effectively kept the "best and brightest" attorneys out of the bankruptcy practice, as they could make more in other fields.[252]

The Commissioners examined pre-Bankruptcy Code practices and generally agreed that bankruptcy professionals often were characterized as "second-class" citizens under the Bankruptcy Act. They did not believe that returning to an "economy of administration" system was a productive pursuit because of its deterrent effect and the resulting negative impact it could have on debtors and their stakeholders in chapter 11 cases.

In rejecting the pre-Bankruptcy Code system, the Commissioners acknowledged that any reforms to professionals' fees in bankruptcy needed to address the criticism that a market does not exist to control or monitor such fees. Indeed, some commentators suggest that bankruptcy professionals set the standards for fees of professionals in other transactional disciplines. Some Commissioners refuted this criticism, noting that the rates of bankruptcy professionals are in fact determined by the market and must be comparable to the rates that such professionals charge clients outside the bankruptcy context.[253] The Commissioners also observed that the criticism may not apply to all bankruptcy professionals, but may be most applicable in the larger chapter 11 cases. Many Commissioners highlighted that the amount of fees and expenses ultimately charged by bankruptcy professionals is driven largely by the complexity of the chapter 11 case and, perhaps more importantly, by the litigious and contentious posture of a case.[254] Regardless, the Commissioners believed that all criticisms of, and potential issues with, the current treatment of bankruptcy professionals' fees had to be considered in studying any reforms, which many Commissioners believed should focus on aligning incentives with case efficiency.

The Commission reviewed several large chapter 11 cases in which professionals' fees and expenses garnered media attention, such as the *American Airlines* and *Tribune Co.* cases, as well as *City of Detroit*, even though it is a chapter 9 case.[255] In these cases,

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[252] Clifford J. White III & Walter W. Theus, Jr., *Professional Fees Under the Bankruptcy Code: Where Have We Been and Where Are We Going?*, Am. Bankr. Inst. J., Dec. 2010/Jan. 2011, at 22.

[253] *See* Lubben, *What We "Know" About Chapter 11 Cost is Wrong*, *supra* note 44, at 147 ("[I]f the market is efficient the professionals are limited in their ability to overcharge. Even if the market is somewhat inefficient, we have to ask if the market is any more inefficient than the larger market for corporate professionals. Bankruptcy professionals seem to be easy to pick on, because their fees are disclosed in open court. However, one might suspect that this same fact may also make them more conservative in their billing.").

[254] *See supra* note 224.

[255] In the *American Airlines* and *City of Detroit* cases, the courts approved the use of fee examiners to review and control professionals' fees and expenses in the cases. Notably, the UST Fee Guidelines "encourage greater use of fee examiners to help evaluate technical compliance (*e.g.*, no lumping of tasks into a single time entry) and assess the reasonableness of a fee request." Cliff J. White III, *New Fee Guidelines for Attorneys in Larger Chapter 11 Cases Enhance Transparency and Promote Market Forces in Billing*, *available at* http://www.justice.gov/ust/eo/public_affairs/articles/docs/2013/abi_201308.pdf.

either the complexity (in the case of *American Airlines*)[256] or the novelty (in the case of *City of Detroit*)[257] of the issues presented and the litigation initiated by stakeholders to protect or pursue their interests in the case (in the case of *Tribune*),[258] or some combination of these factors, contributed to the relatively large amount of professionals' fees and expenses that were incurred in these particular chapter 11 cases.[259] The Commissioners debated whether the Bankruptcy Code could or should scrutinize more closely the conduct of clients and professionals in these circumstances to try to regulate professionals' fees. Such *ex post* oversight by the court, particularly with respect to what actions lawyers should or should not have taken on behalf of their clients, could raise ethical issues for lawyers in chapter 11 cases.[260] Indeed, lawyers generally are required to defer to their clients in service of their clients' lawful objectives.[261] Moreover, professionals are already subject to the "reasonable and necessary" standard of review under Bankruptcy Code section 330 that assesses whether the fees requested by a professional are "reasonable" for actual and "necessary" services rendered by such professional.[262] Lawyers are also subject to a similar standard under their ethical code of conduct enforceable by their respective state bars.[263]

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[256] The *American Airlines* case was filled with complex issues that required negotiation and resolution, including labor union agreements, airport agreements, aircraft leases, intercompany claims, a complicated merger agreement, and an antitrust lawsuit brought by the Department of Justice and the Texas Attorney General. *See* Glenn West & Stephen Youngman, *American Airlines: From Chapter 11 to the World's Largest Airline*, Texas Lawbook (2014), *available at* http://texaslawbook.net/american-airlines-from-chapter-11-to-the-worlds-largest-airline/.

[257] Detroit's "historic" bankruptcy case is the largest municipal bankruptcy in the United States. Matthew Dolan, *Cost of Detroit's Historic Bankruptcy Reaches $126 Million*, Wall St.J. (Sept. 12, 2014, 5:24 PM), http://online.wsj.com/articles/cost-of-detroits-historic-bankruptcy-reach-126-million-1410557043. "Detroit's bankruptcy case has been both complex with more than 100,000 creditors and fast-paced with a goal of exiting bankruptcy as soon as possible so the city can again be run by locally elected officials." *Id.* The cost of the city's bankruptcy case has reached, and is expected to surpass, $126 million, despite the presence of a fee examiner that was appointed by the bankruptcy court to monitor professionals' fees. *Id.* However, city officials and a leading bankruptcy professor who studies professionals' fees agree that the fees are reasonable and consistent with corporate bankruptcy costs, given the size of the case and the city's plans to eliminate $7 billion in debt and reinvest $1.4 billion into blight removal and city services. *Id.*

[258] Morath, *supra* note 206 (noting that *Tribune's* chapter 11 case, "which began in December 2008, is one of the longest-running bankruptcies of the recent financial crisis as an ongoing fight between bondholders and the company has prevented Tribune from exiting Chapter 11 protection").

[259] Similarly, the *Lehman Brothers* bankruptcy case was viewed by a law professor as a "really complicated case" that was "really big and had some novel issues." James O'Toole, *Five Years Later, Lehman Bankruptcy Fees Hit $2.2 Billion*, CNN Money (Sept. 13, 2013), http://money.cnn.com/2013/09/13/news/companies/lehman-bankruptcy-fees/. Judge Peck, the bankruptcy judge who presided over the case, observed that although the fee total was "a whopping number" in absolute terms, it was appropriate given the scale and complexity of the case. *Id.*

[260] "Billing arrangements deal with the business of lawyering, but unlike other business contracts in the marketplace, lawyers cannot engage in unfettered arm's-length transactions to negotiate with and provide services to their clients. . . . Lawyers' duties affect, *ex ante*, the amount of the fees and the kind of arrangements available, the need to adjust fees as the conditions of the representation unfold, and the enforcement of fee contracts *ex post*. The duties owed by lawyers to their clients are founded on basic principles of fiduciary law: the duty of loyalty and fair dealing, and the duty of candor." A.B.A. Comm. on Lawyer Bus. Ethics, *Business and Ethics Implications of Alternative Billing Practices: Report on Alternative Billing Arrangements*, 54 Bus. Law. 175, 190–201 (1998) (discussing various ethical issues that are raised by flat fees and contingency fees).

[261] Model Rules of Prof 'l Conduct R. 1.2(a) (2013) ("[A] a lawyer shall abide by a client's decisions concerning the objectives of representation and . . . shall consult with the client as to the means by which they are to be pursued."); R. 1.4(a)(2) ("A lawyer shall . . . reasonably consult with the client about the means by which the client's objectives are to be accomplished . . . .").

[262] Bankruptcy Code section 330(a) permits a court to award only "reasonable compensation for actual, necessary services rendered by the trustee, examiner, ombudsman, professional person, or attorney and by any

Some Commissioners believed that the Bankruptcy Code could do more to facilitate review of the results achieved by professionals in chapter 11 cases when determining the fees and expenses that should be awarded. For example, the court could grant a supplemental fee for extraordinary results or require disgorgement or reduce requested fees for actions that dissipated the value of the estate. Specifically, the Commissioners debated codifying directives that would require courts to (i) enhance fee awards for "exceptional efficiencies" or "exceptional results" and (ii) reduce lodestar compensation if the court finds that professionals' actions led to otherwise avoidable and unacceptable inefficiencies or outcomes (without making professionals the "guarantors" of chapter 11 outcomes). Some Commissioners highlighted how such directives would be consistent with other decisions made by the Commission to encourage professionals to be more cost-effective in the representation of their clients, including the requirement that professionals for secured creditors and *ad hoc* committees demonstrate the reasonableness of their fees and expenses under section 330 of the Bankruptcy Code.[264] These Commissioners felt that the Bankruptcy Code should induce professionals to strive for efficiency both in terms of the provision of professional services and the results for the estate.

The Commission considered the potential benefits to, and the potential unintended consequences of, such a review process. Although many Commissioners supported the process in concept, they expressed concerns about the implementation of, and the potential litigation invited by, such a results-oriented fee review process. These Commissioners were not persuaded that professionals could avoid the "guarantor" label or the effects of hindsight bias in such a review process. Other Commissioners believed that structuring the review process to focus on administrative efficiencies fostered or impeded by professionals' conduct could significantly mitigate these concerns. The Commissioners were not able to reach a consensus on a results-oriented fee review process because of these concerns, as well as the lack of objective data and academic literature evaluating the advantages and disadvantages of such a review process.

The Commission also considered *ex ante* ways to control and mitigate professionals' fees and expenses in chapter 11 cases. Reliance on the traditional lodestar method of billing and assessing professionals' fees has arguably stifled innovation in fee structures and subjected debtors and unsecured creditors' committees in bankruptcy to a one-size-fits-all fee structure that may be detrimental to bankruptcy estates in certain cases. The Commissioners generally agreed that professionals could develop more efficient ways to deliver cost-effective services to debtors and unsecured creditors' committees.

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paraprofessional person employed by any such person," and permits only "reimbursement for actual, necessary expenses." 11 U.S.C. § 330(a)(1).

[263] Model Rules of Prof'l Conduct R. 1.5(a) (2013) ("A lawyer shall not make an agreement for, charge, or collect an unreasonable fee or an unreasonable amount for expenses."). "Every lawyer practicing in federal bankruptcy court holds at least one state bar card, and every state has an ethics rule regarding the duty of a lawyer to keep fees reasonable." Rapoport, *Rethinking Professional Fees in Chapter 11 Cases*, *supra* note 212, at 291.

[264] *See Professionals and Compensation Issues*. *See also* Wilbur Ross, *Written Statement to the Commission* (Apr. 19, 2013) ("The third problem is the individual large creditor or ad hoc group of such creditors who may or may not be on the official committee for that class but who in any event play a proactive individual role in the proceeding and ultimately seek reimbursement of professional fees based on the argument of 'substantial contribution."), *available at* Commission website, *supra* note 55.

Professionals could provide services on a fixed-fee or flat-rate basis; they could unbundle services and price different aspects of the case in different ways; or they could use discounted or alternative fee models.[265] For example, counsel for the debtor in possession could charge a standard fixed rate for monthly monitoring and administrative matters in a case, a fixed rate for claims administration matters, and an hourly rate (subject to lodestar review) for plan negotiation and confirmation matters.

Some Commissioners observed that alternative fee structures, such as a fixed-fee model, could overcompensate professionals in some cases, such as when the matter is less complex or is resolved more quickly than previously anticipated. Other Commissioners noted that the opposite is also possible when the estate would benefit because professionals underestimated the time and labor that a particular matter would demand.[266] To compensate for this uncertainty, bankruptcy professionals could incorporate escalators or de-escalators in their original fee arrangements to address potential changes in either direction.

As the Commissioners evaluated alternative fee structures, they recognized that the applicable standard of review was very important to the effectiveness of this reform. The standard of review had to permit variation from the traditional lodestar method, but require evidence from the professional that would allow the court to assess *ex ante* the potential advantages and disadvantages of the proposed alternative fee arrangement. The Commissioners did not believe that alternative fee arrangements would be permissible in every scenario, and they believed that courts could be guided (though not bound) by the types of alternative fee arrangements used in the market for comparable engagements and transactions. Indeed, the Commissioners viewed this reform as one way to address the perception that bankruptcy professionals are not compensated in accordance with market standards. The Commission determined that the professional should bear the burden of establishing the reasonableness of the arrangement, that the professional thoroughly reviewed the arrangement with the client (and the client consents to the arrangement), and that the arrangement is reasonably likely to be beneficial to the estate.

The last of these factors — that the arrangement is reasonably likely to be beneficial to the estate — was fully vetted by the Commission. Indeed, the Commissioners contemplated that this factor would allow courts to prospectively consider the impact of proposed alternative fee arrangements. In assessing such

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[265] *See generally* A.B.A. Comm. on Lawyer Bus. Ethics, *supra* note 260, at 182–87 (1998) (describing common types of alternative billing arrangements, including contingency-based fees (*i.e.*, value billing or incentive billing), flat fees (based on tasks or percentages), and modification to hourly billing (*e.g.*, caps, budgets, discounts, or phased billing)). *See also* Nancy B. Rapoport, *The Case for Value Billing in Chapter 11*, 7 J. Bus. & Tech. L. 117, 157–60 (2012) (encouraging law firms to consider alternative fee arrangements).

[266] *See* Rapoport, *Rethinking Professional Fees in Chapter 11 Cases*, *supra* note 212, at 288 ("The advantage of a fixed fee is that it puts the onus of deciding the cost effectiveness of an activity on the person whose bottom line is affected: the professional. The disadvantage, although it's not a major disadvantage, is that the size of the fixed fee could end up being woefully low for the amount of work that the professional needs to do, resulting in the professional having to finish up the job for free."). "The rub with using a flat fee, of course, is that there's a very real possibility that the flat fee will undercompensate the amount of work that the professional has to do. That risk, though, exists in non-bankruptcy cases as well, and as long as clients push for, and get, flat fees outside of bankruptcy, there's no reason that courts can't establish flat fees in bankruptcy cases." Rapoport, *The Case for Value Billing in Chapter 11*, *supra* note 265, at 162.

arrangements under this factor, courts could consider, among other things: (i) how the arrangement might work during the case and the likely impact (both positive and negative) on the estate given various scenarios; (ii) the professionals' justifications for the arrangement and any alternatives to the arrangement; (iii) the use of such arrangements in the market and whether the proposed arrangement includes relevant and customary terms; and (iv) the overall potential benefit to the estate. The Commissioners underscored the need to have the court make these determinations at the beginning of the case or engagement, as applicable, to allow the professional, client, and estate to proceed with confidence in the bargain reached. This approach comports with market standards for alternative fee arrangements and promotes efficiency in their structure and use in chapter 11.

Notably, section 328 currently allows alternative fee structures, and the Commission considered professionals' and courts' frequent reluctance to use or approve such structures.[267] The Commissioners discussed the possible reasons underlying this reluctance. Many Commissioners believed that professionals and courts were reacting, at least in part, to the section 330 imperative, which prompts courts to review professionals' fees and expenses using the lodestar method.[268] Courts apply the lodestar method to determine — after the fact — the "reasonable" amount of attorney's fees for a particular matter by multiplying the number of hours that should have reasonably been devoted to a particular matter by what the court deems to be a reasonable hourly rate. Applying the lodestar method *ex post* to review the amount that a professional has charged pursuant to an alternative fee structure, however, can skew incentives for professionals by creating uncertainty, and make the fee review process more labor-intensive than necessary for the courts.[269]

The Commissioners believed that, whatever the alternative fee agreement, the incentive for professionals to pursue such arrangements would depend, in part, on the willingness of courts to enforce the original terms of the fee agreement, subject to ordinary client defenses (including fraud or misrepresentation) and the current standard of review under section 328. The Commission agreed that the *ex ante* standard of review outlined above would provide appropriate incentives and a meaningful way for courts to assess alternative fee arrangements at the outset. On balance, the Commission

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[267] Bankruptcy Code section 328(a) authorizes "the employment of a professional person under section 327 or 1103 of this title, as the case may be, on any reasonable terms and conditions of employment, including on a retainer, on an hourly basis, on a fixed or percentage fee basis, or on a contingent fee basis." 11 U.S.C. § 328(a). However, section 328(a) also permits courts to deviate from these terms and conditions: "Notwithstanding such terms and conditions, the court may allow compensation different from the compensation provided under such terms and conditions after the conclusion of such employment, if such terms and conditions prove to have been improvident in light of developments not capable of being anticipated at the time of the fixing of such terms and conditions." *Id.*

[268] Section 330(a)(3) of the Bankruptcy Code prompts the court to "consider the nature, the extent, and the value of such services, taking into account all relevant factors, including — (A) the time spent on such services; (B) the rates charged for such services; . . . ." 11 U.S.C. § 330(a)(3).

[269] One bankruptcy court, for example, approved retention of debtor's counsel on the basis of a flat fee pursuant to section 328(a), which the court fixed at the outset at $1,200,000 plus costs. Rapoport, *The Case for Value Billing in Chapter 11*, *supra* note 265, at 161–62 (citing *In re* Kobra Props., 406 B.R. 396 (Bankr. E.D. Cal. 2009)). However, the court also reserved the right to adjust the fee downward based on a reexamination upon the occurrence of certain events or the deviation of the case from a traditional chapter 11 case. *Id.* Ultimately, the court awarded counsel fees that were indeed lower than the flat fee in the retention order. *Id.*

determined that alternative fee structures and more flexibility and innovation in fee structures could generate significant cost savings for bankruptcy estates and could remove a barrier for many companies that could not otherwise afford to pursue a chapter 11 reorganization.

Finally, the Commission reviewed and evaluated recommended principles in other areas that, directly or indirectly, addressed professionals' fees and expenses. For example, the principles discuss the standard of review that should apply to any fees and expenses of professionals for any secured creditor or *ad hoc* committee that requests payment of those amounts from the estate. The Commission agreed that such fees and expenses should be subject to the reasonableness standard of section 330 of the Bankruptcy Code.[270] The principles also clarify the process for the debtor's retention and payment of nonbankruptcy professionals.[271] Furthermore, in reviewing and discussing the U.S. Trustee's appointment of multiple committees in a case, the Commission observed several examples of courts authorizing committees to share professionals.[272]

B. Financing the Case

1. Adequate Protection

Recommended Principles:

- The amount of adequate protection required under section 361 of the Bankruptcy Code to protect a secured creditor's interest in a debtor's property should be determined based on the foreclosure value of the secured creditor's collateral.
- Nothing in this principle prohibits the trustee from seeking to sell a secured creditor's collateral under section 363; in such a sale, the secured creditor's allowed secured claim should be determined by the value actually realized from the sale of its collateral under section 363. In the case of a chapter 11 plan contemplating a reorganization of the debtor, the secured creditor's allowed secured claim should be determined by the reorganization value of its collateral. For the definition of "reorganization value" (which is defined for both the plan and the section 363x sale contexts), see Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.
- For purposes of these principles, the term "foreclosure value" means the net value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale of the secured creditor's collateral under applicable nonbankruptcy law. In evaluating foreclosure value, a court should be able to consider a secured creditor's ability to structure one or more

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[270] *See* Section IV.A.7, *Professionals and Compensation Issues*.

[271] *See id.*

[272] *See id. See also* Rapoport, *Rethinking Professional Fees in Chapter 11 Cases*, *supra* note 212, at 290 ("[N]ot every fiduciary needs its own financial advisor. . . . Perhaps in some cases, one party (the DIP) could pay full freight for a financial advisor's work, and other parties in interest could hire financial advisors for the limited purpose of reviewing the primary financial advisor's work.").

sales, or otherwise exercise its rights, under applicable nonbankruptcy law, in a manner that maximizes the value of the collateral. In the case of a foreclosure sale in which the secured creditor would acquire the collateral through a credit bid, the foreclosure value should be based on the net cash value that a secured creditor would realize upon a hypothetical, commercially reasonable foreclosure sale, and not on the face amount of the debt used to acquire the property through the credit bid.

- The foreclosure value of a secured creditor's collateral should be determined at the time of the request for, or agreement by the parties to provide, adequate protection under section 361. In granting adequate protection to a secured creditor under section 361(3), the court should be able to consider evidence that the net cash value that a secured creditor would realize upon a hypothetical sale of the secured creditor's collateral under section 363 exceeds the collateral's foreclosure value (a "value differential"). If the court makes a finding based on the evidence presented at the adequate protection hearing that a value differential exists, the court should be able to premise adequate protection under section 361, in whole or in part, on such value differential. In so doing, the court's order also should provide that, if the court determines at a subsequent hearing that the secured creditor has presented sufficient evidence to warrant relief from the automatic stay with respect to the collateral, the trustee will conduct a sale of the collateral under section 363, unless the secured creditor elects otherwise. For purposes of this principle, the court may not enforce any waiver or agreement affecting a court's ability to consider evidence and make determinations regarding the existence of a value differential or a secured creditor's entitlement to relief from the automatic stay.
- This formulation of adequate protection complies with the original purpose of section 506(a), which provides that value "shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a). Accordingly, the foreclosure value of a secured creditor's collateral should not necessarily determine the value of such collateral or the secured creditor's allowed claim for other purposes in the chapter 11 case.
- A secured creditor should continue to receive priority treatment under section 507(b) for the foreclosure value of its collateral at the time of its request for adequate protection under section 361. To the extent existing law has been interpreted by courts to mean that the secured creditor must be "provided" with adequate protection in order to gain this benefit, such case law should be overturned by statute. It is sufficient that the secured creditor be deprived of the requested relief from the automatic stay to implicate the protections of section 507(b).
- A court should be able to approve a provision to cross-collateralize a secured creditor's pre-petition debt with the debtor's or the estate's post-petition property only for the purpose of providing adequate protection under section

361 and only to the extent that such cross-collateralization covers any decrease in the value of the secured creditor's collateral as of the petition date.

- The court should not approve any proposed adequate protection under section 361 that grants a lien on, or any direct or indirect interest in (including through a superpriority claim), the estate's avoidance actions or the proceeds of such actions under chapter 5 of the Bankruptcy Code. Nevertheless, this prohibition should not limit the proceeds available to satisfy a pre-petition secured creditor's claim arising solely under section 507(b).

a. Adequate Protection: Background

The filing of a chapter 11 case stays the enforcement of many creditors' actions against the debtor, including the collection and foreclosure actions of secured creditors. Moreover, following a filing, the debtor in possession[273] may continue to use its property, including any cash collateral, to operate its business and to facilitate its reorganization efforts. Although the debtor's right to the automatic stay and the continued use of its property ultimately benefit all stakeholders, the debtor's exercise of these rights directly affects the rights of secured creditors holding interests in the debtor's property. On the other hand, allowing a secured creditor to foreclose immediately on the debtor's property or to demand payment in full from the debtor would crater the debtor's reorganization efforts at the outset; such a provision would essentially turn chapter 11 into a liquidation statute.

The concept of adequate protection is intended in part to balance the pre-petition rights of secured creditors with the post-petition rehabilitative purposes of the Bankruptcy Code. If a debtor seeks to use cash collateral or prime a pre-petition secured creditors' interests as part of, or pursuant to, a post-petition financing arrangement, or if the secured creditor requests relief from the automatic stay that is denied, section 361 of the Bankruptcy Code requires the debtor to provide the secured creditor with adequate protection of its interest in property. The Bankruptcy Code does not define the term "adequate protection," but courts generally have interpreted it to mean compensation to secured creditors for any depreciation or diminution in the value of the secured creditor's interest caused by the debtor in possession's use of collateral during the chapter 11 case.[274] The extent of this protection turns on the court's determination of the "value" of the secured creditors' interest in the debtor's interest in property.[275]

Section 361 offers three nonexclusive means for providing a secured creditor with adequate protection of its secured interest: (i) cash payments; (ii) a replacement lien; or (iii) other protection that will result in the realization of the indubitable equivalent of the

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[273] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[274] *See, e.g.*, United Sav. Ass'n of Tex. v. Timbers of Inwood Forest Assocs., Ltd, 484 U.S. 365 (1988); *In re* Delta Res., Inc., 54 F.3d 722, 730 (11th Cir. 1995), *cert. denied*, 516 U.S. 980 (1995); *In re* Cason, 190 B.R. 917, 928 (Bankr. N.D. Ala. 1995).

[275] *See, e.g.*, Wright v. Union Cent. Life Ins. Co., 311 U.S. 273 (1940).

secured creditor's interest in the property.[276] The language of section 361 is permissive and suggests that other means for providing adequate protection may also exist. Nevertheless, courts and debtors in possession mostly rely on these three articulated means, with the types of adequate protection that would satisfy the third option — providing the indubitable equivalent of the secured creditor's interest — largely determined on a case-by-case basis.[277]

In addition, issues of valuation often are at the heart of the adequate protection determination. Courts have used a variety of valuation standards in assessing the sufficiency of adequate protection under section 361. These standards have included liquidation value, going concern value, and various market valuations.[278] Section 361 does not specify the appropriate valuation standard. In the context of determining the value of a secured creditor's allowed claim, section 506(a) of the Bankruptcy Code provides that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."[279]

b. Adequate Protection: Recommendations and Findings

Adequate protection is a critical determination made early in a chapter 11 case that can affect the ultimate outcome of the debtor's reorganization and creditor recoveries. It serves both to protect the particular interests of secured creditors and to facilitate the overall objectives of the estate. By permitting the use of collateral subject to the provision of adequate protection, the debtor in possession can put its property to work for the estate and focus on implementing an effective reorganization strategy.

The Commissioners engaged in a detailed review of the conceptual underpinnings and purpose of adequate protection under section 361 of the Bankruptcy Code. Although the Commissioners generally agreed on the purpose and importance of the adequate protection concept, they heavily debated and vetted the various approaches to providing adequate protection to secured creditors. The Commissioners discussed the potentially competing needs early in the case from the perspectives of the debtor in possession and the secured creditors. To illustrate, debtors in possession need to use their property — at least such property that is necessary to their reorganization efforts — and they need liquidity typically through post-petition financing and the use of cash collateral. Meanwhile, secured creditors need assurance that the debtor's reorganization efforts will not adversely affect the value of their interests in the debtor's property.

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[276] 11 U.S.C. § 361(1), (2), (3).

[277] The legislative history of section 361(3) suggests that "abandonment of the collateral to the creditor would clearly satisfy indubitable equivalence, as would a lien on similar collateral . . . Unsecured notes as to the secured claim or equity securities of the debtor would not be the indubitable equivalent." H.R. Rep. No. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6544 (statement of Senator Dennis DeConcini).

[278] *See, e.g.*, Christopher S. Sontchi, *Valuation Methodologies: A Judge's View*, 20 Am. Bankr. Inst. L. Rev. 1, 2 & n.5 (2012) ("Broadly speaking, a firm, its assets or its equity can be valued in one of four ways: (i) asset-based valuation where one estimates the value of a firm by determining the current value of its assets, (ii) discounted cash flow or 'DCF' valuation where one discounts cash flows to arrive at a value of the firm or its equity, (iii) relative valuation approaches, which include the 'comparable company analysis' and the 'comparable transaction analysis' that base value on how comparable assets are priced, and (iv) option pricing that uses contingent claim valuation.") (citing cases that considered these various methodologies).

[279] 11 U.S.C. § 506(a).

The Commissioners discussed the kinds of pre-petition liens and security interests often placed on a debtor's property and the impact of a "blanket lien" that encumbers all of the debtor's assets under applicable state law.[280] The Commissioners acknowledged the increasing use of blanket liens in secured financing transactions and discussed the potential value of these liens to the extent they reduce the cost of capital and provide pre-petition liquidity to the debtor. The Commissioners also recognized the general proposition, which is reflected in the legislative history of section 361, that the Bankruptcy Code should provide secured creditors with the value of their pre-petition bargain.[281] To that end, the Commission considered the various ways of providing secured creditors with the value of their pre-petition bargain in the context of adequate protection.

Given that adequate protection turns on the value attributable to the secured creditor's interest in a debtor's interest in property, the Commission discussed the various methods of determining such value, explored situations in which different methods may apply, and considered the consequences to the estate and secured creditors of applying these methods. First, the Commission evaluated the potential use of "liquidation value," which is typically applied in the event of a forced or orderly liquidation. The use of a forced liquidation standard may produce a lower valuation of the property interest, facilitating the debtor's use of the property, but potentially reducing the secured creditor's recoveries in the case. Second, the Commission evaluated the potential use of "going concern value," which is used to evaluate the enterprise value of a debtor with an assembled workforce and operating business.[282] The use of a going concern valuation may produce a higher valuation of the property interest, providing greater protection of the secured creditor's interest in the debtor's property, but perhaps reducing significantly the debtor's financing and reorganization options. A going concern valuation also may provide more protection than necessary in those cases when the secured creditor does not have an interest in the entirety of the debtor's assets.[283]

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[280] *See, e.g.*, Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter* 11, 1 J. Legal Analysis 511, 523 (2009) (reviewing prepetition financing arrangements and observing that approximately 97 percent of prepetition financing facilities are secured by liens akin to blanket liens). *See also* Juliet M. Moringiello, *When Does Some Federal Interest Require a Different Result?: An Essay on the Use and Misuse of* Butner v. United States, 2015 Ill. L. Rev. , at *33 (forthcoming 2015) ("These blanket liens, coupled with the expanded definition of proceeds as a result of the 2001 amendments to Article 9 of the Uniform Commercial Code, leave no unencumbered assets for unsecured creditors. Some have argued that the 2001 amendments to Article 9 impermissibly amend bankruptcy law."), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2445584.

[281] H.R. Rep. No. 95-595 (1977) ("Secured creditors should not be deprived of the benefit of their bargain. . . . [T]he purpose of the section is to insure that the secured creditor receives the value for which he bargained.")

[282] *See generally* ROBERT RHEE, ESSENTIAL CONCEPTS OF BUSINESS FOR LAWYERS 155–59 (2012) (explaining different ways to value a company).

[283] A secured creditor may have interests in only certain of the debtor's assets or something less than the entirety of the enterprise. *See, e.g.*, Melissa B. Jacoby & Edward J. Janger, *Ice Cube Bonds: Allocating the Price of Process in Chapter 11 Bankruptcy*, 123 Yale L.J. 862, 922–23 (2013) ("Yet, not all property can be encumbered by a security interest as a legal or practical matter. Whatever the intentions of the parties, the so-called blanket lien is likely to have gaps."). *See also* Edward Janger, *The Logic and Limits of Liens*, 2015 Ill. L. Rev. , at *5–6 (forthcoming 2015) (noting that so-called blanket liens under Article 9 of the Uniform Commercial Code may exclude tort claims, real estate, recoupment and setoff claims, insurance claims, and others); Michelle M. Harner, *The Value of Soft Assets in Corporate Reorganizations*, 2015 Ill. L. Rev. , at *24 (forthcoming 2015) ("If a company holds a going concern surplus … some portion of that value is attributable to soft variables and, if realized post-petition, is not (or should not be) subject to a prepetition security interest. … [There is] support for this position under the Bankruptcy

Ultimately, however, the Commission agreed that, for purposes of determining adequate protection under section 361, a secured creditor's interest in the debtor's property should be determined based on the "foreclosure value" of such interest, instead of more commonly used valuation standards such as liquidation value and going concern value. The foreclosure standard is meant to capture the value of the secured creditor's interest as of the petition date (i.e., the value that a secured creditor's state law foreclosure efforts would produce if the automatic stay were lifted or the bankruptcy case had not been filed).[284] The foreclosure value should be determined case by case based on the evidence presented at the adequate protection hearing, taking into account the realities of the applicable foreclosure markets and legal schemes.

Notably, the Commission's decision to use foreclosure value is an integral part of the delicate balance the Commission struck between the rights of secured creditors, on the one hand, and the reorganizational objectives of the estate, on the other hand. Specifically, the Commission agreed that the foreclosure value of an interest should be used early in the case when determining adequate protection issues, but that the secured creditor should be entitled to receive the reorganization value of its interest in the debtor's property through the claims allowance and distribution process later in the case.[285]

In addition, the Commission agreed that a secured creditor should receive additional assurances if the court permits the debtor to provide adequate protection by showing a sufficient equity cushion in the property — i.e., a sufficient differential between the foreclosure value and the section 363x sale value of the secured creditor's interest in the debtor's property. In this instance, the Commission determined that the court should have the ability to provide in the adequate protection order that, if the debtor in possession's reorganization efforts fail, or if the court subsequently finds cause that would support lifting the automatic stay with respect to the secured creditor's collateral, the debtor in possession or the chapter 11 trustee must sell the secured

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Code."), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2444699. *But see First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 4–5 (Nov. 15, 2012) ("While some commentators have advocated limiting a secured creditor's interest to 'liquidation value' while preserving incremental 'going-concern surplus' for the benefit of others, CFA submits that prepetition lending expectations should be preserved. For example, with an increasingly large segment of the secured lending market dedicated 'cash-flow lending' predicated upon the present value of anticipated future income streams or cash-flows based upon a multiple of EBITDA, when those proceeds are realized upon a sale (whether voluntary or involuntary), the net proceeds of sale should be allocable to the secured party. On the other hand, consistent with pre-bankruptcy expectations, the secured creditor should also be required to bear the reasonable costs and expenses incurred in connection with the preservation and disposition of the collateral (a concept presently addressed by §506(c) of the Code). Accordingly, CFA believes that the Commission should consider codifying the principal that the secured creditor's interest includes the realizable value of the collateral including going-concern value."), *available at* Commission website, *supra* note 55.

[284] Under the parties' prepetition agreements, the secured creditor generally is entitled to foreclose on its collateral upon the debtor's default. The chapter 11 case and the automatic stay prevent a secured creditor from being able to exercise its state law foreclosure rights. The foreclosure valuation standard for adequate protection purposes preserves the value of the secured creditor's interest under its prepetition bargain with the debtor. Edward Janger, *The Logic and Limits of Liens*, *supra* note 283 (arguing that the lienholder *should* only be entitled to the value it could have received if it had pursued state law remedies) (emphasis added). As discussed below, however, the Commission determined that for distribution purposes in the case, a secured creditor should be entitled to receive the reorganization value of its collateral.

[285] The term "reorganization value" and its role in the claims distribution process is discussed below. *See* Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.

creditor's collateral under section 363 of the Bankruptcy Code, unless the secured creditor elects otherwise. This compromise reflects the reality that, if adequate protection is provided based on the reorganization value of the collateral, the secured creditor should have a means of realizing such reorganization value if adequate protection is subsequently proven to insufficiently protect the secured creditor's interests. Although the Commissioners discussed potential ways that secured creditors could try to impede the debtor's reorganization efforts by triggering their need for additional assurance, the Commission ultimately determined that the court could monitor such conduct by enforcing its orders. Moreover, the Commission concluded that such conduct is rare and likely counterproductive for the secured creditor, which would otherwise be entitled to receive the reorganization value (which is defined in the sale context as the actual sale price) of its collateral upon the confirmation of the debtor's plan or the approval of a section 363x sale.

The Commissioners discussed the general uses for, and the current split in the case law regarding the permissibility of, cross-collateralization. They recognized that, on the one hand, cross-collateralization may serve valid interests that would benefit the estate, but on the other hand, it may also result in overreaching and an impermissible improvement of a pre-petition lender's position. The Commission ultimately decided that debtors in possession should be able to use cross- collateralization to provide adequate protection to pre-petition secured creditors, but only to the extent that such cross-collateralization would protect against the decrease in the value of the secured creditor's interest in the debtor's property.

The Commission also considered whether a debtor in possession should be able to grant a replacement lien in its chapter 5 avoidance actions or the proceeds of such actions to provide adequate protection to a secured creditor under section 361.[286] The Commission reviewed the original policies underlying the trustee's avoiding powers under chapter 5 of the Bankruptcy Code, including allowing the trustee to avoid pre-petition transfers that preferred certain unsecured creditors and reallocating the recovered value from such avoidance actions more fairly through the bankruptcy claim distribution process. The Commissioners also observed that chapter 5 avoidance actions and recoveries often are among the few unencumbered assets of a debtor's estate and therefore may be the only resource available to repay unsecured claims. On balance, the Commission determined that the debtor in possession should not be permitted to use chapter 5 avoidance actions or recoveries to provide adequate protection to secured creditors. The only exception to this general rule is that if the adequate protection granted to a secured creditor is determined to be insufficient, then such secured creditor should be allowed to receive recoveries from avoidance actions through the creditor's superpriority claim under section 507(b) of the Bankruptcy Code.

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[286] For a discussion of the treatment of liens in chapter 5 avoidance actions in the post-petition financing context, *see* Section V.C, *Avoiding Powers*.

2. Terms of Postpetition Financing

Recommended Principles:

- A court should not approve any proposed post-petition financing under section 364 of the Bankruptcy Code that contains a provision to roll up pre-petition debt into the post-petition facility or to pay down pre-petition debt in part or in full with proceeds of the post-petition facility. This provision should not apply to post-petition financing, including a facility that refinances in part or in full pre-petition debt, to the extent that —
  - the post-petition facility (a) is provided by lenders who do not directly or indirectly through their affiliates hold pre-petition debt affected by the facility or (b) repays the pre-petition facility in cash, extends substantial new credit to the debtor, and provides more financing on better terms than alternative facilities offered to the debtor; and
  - the court finds that the proposed post-petition financing is in the best interests of the estate.
- A court should not approve any proposed post-petition financing under section 364 that grants a lien on, or any interest in (including through a superpriority claim), the estate's avoidance actions or the proceeds of such actions under chapter 5 of the Bankruptcy Code.
- Subject to a 60-day restriction on milestones, benchmarks, and similar provisions (see Section IV.C.1, *Timing of Approval of Certain Post-petition Financing Provisions*), a court should be able to approve, in a final order, permissible extraordinary financing provisions in connection with any proposed post-petition financing under section 364. For the definition of "permissible extraordinary financing provisions," see Section IV.C.1, *Timing of Approval of Certain Post-petition Financing Provisions*.
- Any pre-petition contractual prohibition on subordinated pre-petition junior secured creditors offering or providing post-petition financing to the debtor should not be enforced in the chapter 11 case, provided that: (i) any such subordinated pre-petition junior secured creditors should not be permitted to prime the perfected security interests of the pre-petition senior secured creditors with the post-petition financing facility; and (ii) if the court approves the post-petition financing facility offered by the subordinated pre-petition junior secured creditors, the pre-petition senior secured creditors should have the option to match the terms of, and to provide the financing facility in lieu of, the subordinated junior secured creditors within a reasonable time as specified in the court's interim order approving the post-petition financing. These provisions would render unenforceable any contractual damages provisions that would otherwise allow pre-petition senior secured creditors to recover damages for breach of contract against subordinated pre-petition junior secured creditors under nonbankruptcy law based on the provision of post-petition financing. Sections 364 and 510 should be amended accordingly.

a. Terms of Post-petition Financing: Background

A debtor in possession[287] needs liquidity to operate its business during the chapter 11 case and to finance its reorganization efforts. Some debtors in possession may be able to use cash collateral and its ongoing revenue streams for these purposes, but many debtors need a new, post-petition financing facility to achieve their post-petition objectives.[288] Section 364 of the Bankruptcy Code generally governs a debtor in possession's requests to obtain post-petition financing.

Section 364 is structured in part to incentivize lenders to extend credit to a company in bankruptcy.[289] Currently, this section permits a debtor in possession to obtain post-petition financing on either an unsecured basis or, after notice and a hearing, in exchange for administrative priority.[290] In addition, upon making certain showings, a debtor may be authorized to incur post-petition debt as a superpriority administrative claim, a secured claim in unencumbered property, a junior secured claim, or a senior secured claim (by priming pre-petition senior secured creditors).[291] The last of these incentives is the most difficult for debtors in possession to obtain because section 364(d) requires the debtor in possession to show that no other financing is available and that the interests of the pre-petition secured creditors that would be primed by the new facility are adequately protected.[292]

Because a debtor in possession may not be able to prime its pre-petition secured lenders under the current standards for adequate protection, a debtor in possession often tries to negotiate a post-petition financing facility with its pre-petition secured lenders. Such post-petition facilities may include cross-collateralization or roll-up provisions that provide additional protection to the pre-petition lenders on their pre-petition claims against the estate. Whether a court should approve cross-collateralization and roll-up provisions is subject to debate and frequently depends on the jurisdiction in which the chapter 11 case is pending.[293] In addition, the debtor may be limited to negotiating its

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[287] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[288] Prepetition loan agreements are considered "financial accommodations" that the trustee cannot elect to assume (and thereby require performance) under section 365 of the Bankruptcy Code. "[Section 365(c)] permits the trustee to continue to use and pay for property already advanced, but is not designed to permit the trustee to demand new loans or additional transfers of property under lease commitments." H.R. Rep. 95-595, 1978 U.S.C.C.A.N. 5963, 6304. Accordingly, the debtor in possession needs to negotiate a new financing arrangement, which may be provided by new lenders or some or all of its prepetition lenders.

[289] *See, e.g.*, Paul M. Baiser & David G. Epstein, *Post-petition Lending Under Section 364: Issues Regarding the Gap Period and Financing for Prepackaged Plans*, 27 Wake Forest L. Rev. 103, 103–04 (1992) ("To counter the understandable reluctance of financial institutions to lend to Chapter 11 debtors, section 364 of the [Bankruptcy] Code provides incentives to lenders to provide financing to borrowers who are the subject of bankruptcy cases.") (citations omitted).

[290] 11 U.S.C. § 364(a) (unsecured credit); *id.* § 364(b) (administrative claim).

[291] *Id.* § 364(c) (superpriority administrative claim, junior lien, or lien on unencumbered property); *id.* § 364(d) (priming lien).

[292] *Id.* § 364(d)(1) (requirements for priming lien); *id.* § 364(d)(2) (burden on the trustee/debtor in possession).

[293] For cases allowing cross-collateralization, *see In re* Ames Dep't Stores, Inc., 115 B.R. 34, 39–40 (Bankr. S.D.N.Y. 1990); *In re* FCX, Inc., 54 B.R. 833, 840 (Bankr. E.D.N.C. 1985); *In re* Vanguard Diversified, Inc., 31 B.R. 364, 366 (Bankr. E.D.N.Y. 1983); *In re* Gen. Oil Distrib., Inc., 20 B.R. 873, 875–76 (Bankr. E.D.N.Y. 1982). For cases disallowing cross-collateralization, *see* Shapiro v. Saybrook Mfg. Co., Inc. (*In re* Saybrook Mfg. Co.,

post-petition financing facility with only its pre-petition senior secured creditors if the debtor's pre-petition junior secured creditors are prohibited from extending post-petition financing to the debtor pursuant to a pre-petition intercreditor or subordination agreement.[294]

b. Terms of Post-petition Financing: Recommendations and Findings

The Commissioners analyzed a variety of issues relating to debtor in possession financing. They considered, among other things, the impact of the terms of a post-petition facility on the chapter 11 case and the debtor's stakeholders, as well as the importance of a robust financing market to the chapter 11 process. The Commissioners discussed the kinds of provisions that protect the interests of post-petition lenders and encourage the extension of credit to chapter 11 debtors. Some Commissioners suggested that lenders do not need additional incentives because post-petition financing has historically been not only safe, but also very profitable.[295] Other Commissioners challenged this assumption, noting the tightening of the post-petition credit market during the 2008 financial crisis.[296]

Inc.), 963 F.2d 1490, 1494–96 (11th Cir. 1992) (cross-collateralization is *per se* impermissible); *In re* Texlon Corp., 596 F.2d 1092 (2d Cir. 1979); *In re* Fontainebleau Las Vegas Holdings, LLC, 434 B.R. 716 (S.D. Fla. 2010). For cases allowing roll-ups in certain circumstances, *see In re* Uno Rest. Holdings Corp., Ch. 11 Case No. 10-10209 (MG) (Bankr. S.D.N.Y. Jan. 20, 2010); *In re* Foamex Int'l Inc., Ch. 11 Case No. 09-10560 (KJC) (Bankr. D. Del. Feb. 18, 2009); *In re* Aleris Int'l, Inc., Ch. 11 Case No. 09-10478 (BLS) (Bankr. D. Del. Feb. 12, 2009); *In re* Tronox Inc., Ch. 11 Case No. 09-10156 (ALG) (Bankr. S.D.N.Y. Jan. 12, 2009); *In re* Lyondell Chem. Co., Ch. 11 Case No. 09-10023 (REG) (Bankr. S.D.N.Y. Jan. 6, 2009). Notably, the permissibility of these and other provisions in a post-petition facility are governed by section 364 of the Bankruptcy Code and are generally protected on appeal and subject only to reversal if lack of good faith is established. *See* 11 U.S.C. § 364(e).

[294] For a general discussion of issues in intercreditor agreements, *see* Mark N. Berman & David Lee, *The Enforceability in Bankruptcy Proceedings of Waiver and Assignment of Rights Clauses Within Intercreditor or Subordination Agreements*, 20 Norton J. Bankr. L. & Prac., Art. 1 (2011).

[295] *See, e.g.*, Marshall S. Hueber, *Debtor-in-Possession Financing*, RMA J., Apr. 2005, at 33 ("[DIP lending] can be an eminently logical and profitable endeavor. Indeed, because of the many lender protections enshrined in the U.S. Bankruptcy Code to induce DIP lending, the safest loans in a troubled industry may well be those made to bankruptcy debtors."); David A. Skeel, Jr., *The Past, Present and Future of Debtor-in-Possession Financing*, 25 Cardozo L. Rev. 1905, 1906 (2004) ("[T]he generous terms offered to DIP financers have encouraged lenders to make loans to cash-starved debtors, and that these lenders have used their leverage to fill a governance vacuum that was created by the enactment of the 1978 Code."); Joseph V. Rizzi, *Opportunities in DIP Financing*, Bankers Mag., July/Aug. 1991, at 49 ("New post-petition lenders can earn attractive returns from relatively secure assets and participate in a growing market."). *See also Written Statement of Kathryn Coleman, Attorney at Hughes Hubbard & Reed, LLP: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–6 (Nov. 3, 2012) (noting that DIP lending is profitable and safe but is no longer being used to help rehabilitate the debtor and arguing that some roll-up facilities can have a significant negative effect on a debtor's ability to exit chapter 11), *available at* Commission website, *supra* note 55.

[296] *See, e.g.*, Kenneth Ayotte & David A. Skeel, Jr., *Bankruptcy or Bailouts?*, 35 Iowa J. Corp. L. 469, 488 ("A system-wide lending failure like the recent credit crisis raises the question whether private sources of bankruptcy financing will always be available. Through much of 2008, few companies that filed for bankruptcy were able to obtain financing."); Robert H. Barnett & Brian J. Grant, *Credit Crisis Puts Focus on Out-of-Court Restructurings*, J. Corp. Renewal, June 14, 2010 ("DIP financing sources seized up at the onset of the credit crunch and banking crisis in 2008. Several large institutions in the third quarter of that year dramatically tightened new DIP lending; Lehman Brothers filed for bankruptcy in September of 2008, and Merrill Lynch and Wachovia, two other top players in the market, were sold in last-minute distressed deals to Bank of America and Wells Fargo, respectively. As credit vanished throughout the financial system, other DIP lenders followed suit. . . . [T]he number of active DIP lenders dropped from more than 30 at the beginning of 2008 to only five or six by the end of the year. Aside from some high-profile deals in which lenders pulled together to support large companies (such as Lyondell

The Commission reviewed extensive materials on post-petition financing markets, terms, and impact, including a detailed report from the advisory committee and data compiled by the Loan Syndications and Trading Association (the "LSTA").[297] The LSTA's data suggest that the majority of debtors that enter into post-petition financing agreements do not liquidate, but rather reorganize.[298] Specifically, based on the Commission's review of the LSTA data: (i) 69 percent of firms that had post-petition financing reorganized, whereas 52 percent of firms that did not have post-petition financing reorganized; (ii) 38 percent of firms without post-petition financing liquidated, whereas 23 percent of firms with post-petition financing liquidated; (iii) 16 percent of firms that had post-petition financing were eventually sold pursuant to a section 363 sale, whereas only 8 percent of firms that did not have post-petition financing were sold pursuant to a section 363 sale; and (iv) any relationship between post-petition financing agreements and chapter 7 liquidations is inconclusive.[299]

In addition, the Commissioners evaluated testimony that (i) markets for secured leveraged debt, especially with the benefits of senior secured status, and high-yield bonds are large and critical to economic growth; (ii) secondary trading markets are deep and liquid even during times of great distress; (iii) assets in bankruptcy are liquid and

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Chemical Co.'s $8 billion Post-petition financing facility, which came with a 13 percent interest rate and a 7 percent fee), DIP financing remained scarce in 2009, forcing companies either to restructure by other means or to move straight to liquidation."), *available at* http://www.turnaround.org/ Publications/Articles.aspx?objectID=13015.

[297] The LSTA dataset is found at Exhibit B, with related materials at Exhibits A and C, to Mr. Shapiro's supplemental testimony. *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to*

Study the Reform of Chapter 11, at Exhibits A, B, C (Nov. 30, 2012), *available at* Commission website, *supra* note 55. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[298] The Commission appreciated the LSTA's contribution to the field hearings and its work on this dataset. The LSTA's dataset focuses on post-petition financing facilities in large chapter 11 cases since 2006. It is an extension of the UCLA-LoPucki Bankruptcy Research Database, and it records information on chapter 11 cases filed since 2006 with reported assets of between $500 million and $10 billion, with the addition of five cases not in the UCLA-LoPucki Bankruptcy Research Database. The LSTA dataset contains 167 observations, with each observation representing a separate post-petition financing facility (so one company may have multiple observations if it had more than one facility or filed more than one chapter 11 case). Of the 167 observations, 157 of the observations are unique cases, reflecting the fact that some firms have more than one DIP facility per case. Of these, 149 are unique companies, reflecting the fact that 8 firms have filed for bankruptcy more than once in the dataset. *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at Exhibit C (Nov. 30, 2012), *available at* Commission website, *supra* note 55. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[299] These analyses were based on the data in Exhibit B to Mr. Shapiro's supplemental testimony. *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at Exhibit B (Nov. 30, 2012), *available at* Commission website, *supra* note 55. In performing these analyses, cases with multiple post-petition financing observations and the cases added to the dataset from outside of the UCLA-LoPucki Bankruptcy Research Database (they did not meet the criteria of the original database and could skew observations; notably, the percentages do not vary greatly if all observations are included) were excluded. Accordingly, these data are based on 157 cases: 91 of these cases had a post-petition financing facility; 69 percent (or 63 out of 91) of cases reorganized. This means 31 percent (or 28 out of 91) of cases did not reorganize. Conversely, 42 of the cases did not have DIP Financing; 52 percent (or 22 out of 42) of cases reorganized; 48 percent (or 20 out of 42) of cases did not reorganize. It is important to note that 24 of these cases were missing data. Also, these observations are limited by the qualifications typically associated with empirical analyses of chapter 11 cases, as well as the fact that the dataset was missing some data and focused only on large, public company cases. Nevertheless, the data are still very informative, and align with general perceptions that many distressed companies need some form of post-petition financing to use chapter 11 effectively. *Id. See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

volatile, but can appreciate and increase the enterprise value or provide a less certain path toward profitability; and (iv) debtor in possession financing provides much needed liquidity to distressed companies at market rates based on the risk profile of the particular debtor.[300] They also considered testimony that post-petition financing agreements include tighter covenants and milestones often designed to facilitate a loan-to-own transaction for the lender or a sale of the assets in the chapter 11 case.[301] In reviewing the testimony, the Commissioners debated the advantages and disadvantages of post-petition financing terms.[302]

As a general matter, the Commissioners recognized the need for a robust, competitive post-petition financing market and the value it provides to distressed companies. They also appreciated the potential impact that any suggested reforms

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[300] *Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing leveraged loan and high yield markets and noting resulting liquidity to distressed companies), *available at* Commission website, *supra* note 55; *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Nov. 30, 2012) (explaining dynamics of post-petition financing negotiations and detailing components of, and factors considered in pricing, such financing), , *available at* Commission website, *supra* note 55. "The DIP lending market provides a complex and challenging arena for lenders. Not only must they engage in all analyses that are attendant to a more typical loan to a non-distressed commercial borrower, but they also must understand the legal and financial framework that encompasses a potential borrower in a Chapter 11 case, including the impact of Chapter 11 on the Debtor's business." *Id. See also* Edward I. Altman, *The Role of Distressed Debt Markets, Hedge Funds and Recent Trends in Bankruptcy on the Outcomes of Chapter 11 Reorganizations*, 22 Am. Bankr. Inst. L. Rev. 75, 84 (2014) (observing that the size and sophistication of the distressed debt market has "provided the incentive for a special breed of investors, experienced in distressed investing, to attract capital and . . . provide a potential outlet for original investors to monetize their troubled assets. . . . This liquidity is crucial to those [] investors who do not have the resources, expertise or desire to hold their claims until the resolution of the reorganization" and impacts other financing markets").

[301] *See, e.g., Written Statement of Kathryn Coleman, Attorney at Hughes Hubbard & Reed, LLP: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (Nov. 3, 2012) ("Regardless of where the debtor gets its DIP financing, the game has dramatically changed. Lenders providing post-petition financing no longer do so in order to make good returns with assured repayment, or protect their prepetition positions by getting collateral for previously unsecured loans. Instead, they often do so in order to take control of the debtor, through covenants, deadlines, and default provisions. And these are no mere financial tests to ensure the safety of the lender's repayment."), *available at* Commission website, *supra* note 55; *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013) ("Post BAPCPA, DIP agreements routinely require a full resolution to the case or rejection of any lease not consensually extended by the 210th day. In the case of a retailer . . . [this] effectively shorten[s] the timeline to reorganize the company to generally only 120 days and sometimes as short as 90 days . . . ." and this generally means that the debtor's management often has very little time to decide whether to pursue reorganization by obtaining consensual lease extensions or to begin a sale process.), *available at* Commission website, *supra* note 55; *Oral Testimony of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 40–42 (Nov. 3, 2012) (TMA Transcript) (arguing there should be a presumption against rollups, particularly where the company seeks to reorganize rather than sell), *available at* Commission website, *supra* note 55. *See also* Stephen J. Lubben, *The Board's Duty to Keep Its Options Open*, 2015 Ill. L. Rev. , at *4–5 (forthcoming 2015) ("But in many cases, the reality is that the debtor has no choice but to commence a sale process, because its DIP loan only provides funding for a relatively short period of time. Lenders are able to impose such terms on debtors because the lender has a virtual stranglehold on the debtor's operations coming into bankruptcy by virtue of a lien on all of the debtor's assets and possession of all the debtor's cash."), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2434699.

[302] *See, e.g.*, Kenneth N. Klee & Richard Levin, *Rethinking Chapter 11*, 21 Norton J. Bankr. L. & Prac. 5 (2012) (discussing use of roll-ups and milestones in post-petition financing agreements); *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Nov. 30, 2012) (reviewing various types of milestone, benchmark, roll-up, and other post-petition financing terms and their role in structuring and pricing the agreement; also addresses criticisms of such provisions), *available at* Commission website, *supra* note 55.

might have on that market; they aimed to encourage a competitive post-petition financing market that provided debtors with access to necessary financing on terms that would facilitate their restructuring efforts — an outcome that benefited all stakeholders. Accordingly, the Commissioners carefully analyzed the materials discussing, and the implications of issues involving post-petition financing. The Commissioners further acknowledged that the focus of section 364 should be on permitting parties to negotiate market agreements that do not overreach or negatively impact the rights of other stakeholders beyond the terms necessary to obtain post-petition credit in a particular case.

To strike this balance, the Commissioners first evaluated the use of roll-up and cross-collateralization provisions in post-petition facilities. The Commissioners discussed the different kinds of roll up provisions and their different justifications, specifically comparing provisions in post-petition facilities provided by a pre-petition lender with provisions in post-petition facilities provided by a completely new lender.[303] The Commissioners generally agreed that the greatest opportunity for abuse in the context of roll-up provisions occurs when a pre-petition lender provides a post-petition facility and the true "new credit" extended by such facility may be nominal (or nominal in relation to the amount of pre-petition debt rolled up into the post-petition facility).[304] Although the Commission viewed a refinancing with a new lender differently, the Commission also noted the potential challenge in distinguishing among pre-petition and post-petition lending groups. To assist in this task, the Commission methodically

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[303] "When the debtor in possession's prepetition lender is acting as the post-petition lender, the elimination of prepetition debt — termed a 'roll–over' — often attracts intense scrutiny from the court and the United States trustee. Roll-overs come in two basic forms. First, a gradual roll-over occurs when a prepetition lender agrees to advance post-petition funds with the agreement that proceeds of prepetition accounts receivables will be applied to reduce the prepetition loan. Alternatively, a post-petition lender can simply lend enough post-petition to pay off the prepetition loan, whether owing to the post-petition lender or a different lender, immediately converting all of the lender's prepetition debt to post-petition debt. Post-petition lenders often prefer the latter alternative because they prefer to be the sole holder of a lien on the collateral pool." 3 Collier on Bankruptcy ¶ 364.04[1] [e]. *See also In re* Capmark Fin. Grp. Inc., 438 B.R. 471, 511 (Bankr. D. Del. 2010) (explaining that a "roll-up" is "the payment of a pre-petition debt with the proceeds of a post-petition loan. Roll-ups most commonly arise where a pre-petition secured creditor is also providing a post-petition financing facility under section 364(c) or (d) of the Bankruptcy Code. The proceeds of the post-petition financing facility are used to pay off or replace the pre-petition debt, resulting in a post-petition debt equal to the pre-petition debt plus any new money being lent to the debtor. As a result, the entirety of the pre-petition and post-petition debt enjoys the post-petition protection of section 364(c) or (d) as well as the terms of the DIP order."); Mark J. Roe & Frederick Tung, *Breaking Bankruptcy Priority: How Rent-Seeking Upends The Creditors' Bargain*, 99 Va. L. Rev. 1235, 1238 (2013) ("[B]ank lenders have convinced judges to "roll up" their possibly unsecured pre-bankruptcy debts — debts that were quite likely not entitled to priority payment — into new, secured, and highly-prioritized loans to the debtor in bankruptcy.").

[304] The Commission considered the testimony of Mark Shapiro, who in part analyzed the LSTA data and concluded that only about 10 percent of the 167 observations (total sample) in the LSTA dataset involved a post-petition financing with roll-up provisions that resulted in the conversion of a case to chapter 7, approval of a section 363 sale of substantially all of its assets, or confirmation of a liquidating plan. *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 7 (Nov. 30, 2012), *available at* Commission website, *supra* note 55. The Commissioners also observed in the LSTA dataset, however, a correlation between post-petition financing agreements with roll-up provisions and some type of milestone or benchmark requirement. Specifically, if the financing included a roll-up, it was more likely to also include milestones or benchmarks. These analyses were based on the data in Exhibit B to Mr. Shapiro's supplemental testimony. *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at Exhibit B (Nov. 30, 2012), *available at* Commission website, *supra* note 55. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

worked through the various scenarios in which one or more pre-petition lenders may participate in a post-petition facility that provides new credit to the debtor in possession. The Commission crafted the related principles to allow roll-up provisions in those circumstances if certain conditions are met, but to disallow roll-up provisions that provide little or no value to the estate.

With respect to cross-collateralization, the Commissioners discussed its uses and the split in the case law regarding the permissibility of cross-collateralization. The Commissioners articulated concerns similar to those expressed in the roll-up context. In fact, some of the Commissioners viewed cross-collateralization as subject to greater abuse because of the ability of pre-petition lenders to improve their pre-petition position through the use of cross-collateralization in post-petition facilities. As noted in the adequate protection principles above, the Commission ultimately supported the ability of a debtor in possession to use cross-collateralization, but only in the adequate protection context and only to the extent such cross-collateralization is used if there is actual diminution in the value of a secured creditor's interest in the debtor's property.[305]

The Commission considered whether a debtor in possession should be able to grant post-petition lenders a lien in its chapter 5 avoidance actions or the proceeds of such actions to secure the post-petition facility. As discussed above in the adequate protection context, the Commission reviewed the original policies underlying the trustee's avoiding powers under chapter 5 of the Bankruptcy Code and the estate's unique interests in such assets. The Commission determined that the debtor in possession should not be permitted to use chapter 5 avoidance actions or the proceeds of such actions (directly or indirectly through any superpriority claim) to secure post-petition financing under section 364 of the Bankruptcy Code. In the adequate protection context, section 507(b) of the Bankruptcy Code grants pre-petition lenders a superpriority claim in situations when they have sought adequate protection, and adequate protection has failed. In contrast, a post-petition lender has other means to secure or protect its post-petition extension of credit to the debtor from the outset.

The Commissioners also evaluated the impact of provisions in a pre-petition intercreditor or subordination agreement that precludes a pre-petition junior secured lender from offering post-petition financing to the debtor without the consent of the senior secured lender. This kind of waiver by a junior lender in the pre-petition intercreditor agreement can have a significant negative impact on the debtor in possession, who is often not a party to the agreement. Among other things, this waiver often removes an interested and viable source of financing from the debtor's pool of potential post-petition lenders, which may affect both the availability and terms of any post-petition financing for the debtor in possession.

The Commissioners recognized that this kind of waiver is increasingly common in intercreditor agreements, along with a variety of other provisions that affect bankruptcy rights, including rights of the debtor and potentially other nonparties to the intercreditor agreement. The Commissioners discussed the role and value of these provisions from the perspective of the pre-petition senior secured lenders. The Commissioners debated different ways to provide the debtor with the ability to discuss post-petition financing

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[305] *See* Section IV.B.1, *Adequate Protection*.

with junior lenders subject to this kind of waiver while still respecting the interests of the pre-petition senior secured lenders. The Commission reached a consensus that would allow a subordinated junior secured lender subject to this kind of waiver and prohibition to provide post-petition financing to the debtor on two conditions: (i) the proposed facility does not prime the liens of the pre-petition senior secured lender, and (ii) if the court approves the post-petition facility offered by such junior lenders, the pre-petition senior secured lender has the right to step in and provide post-petition financing (in lieu of the financing offered by the junior lender) to the debtor on the same terms and subject to the same conditions as the post-petition facility offered by the junior secured lender and approved by the court. In that event, the Commission supported an amendment to the Bankruptcy Code rendering unenforceable any contractual damages provisions that would otherwise allow senior secured creditors to recover damages for breach of contract against junior secured creditors under nonbankruptcy law based on the provision of post-petition financing.[306] In addition, the Commission agreed that the senior secured lenders should be required to take such action within a reasonable time as directed by the court in the interim financing order.

C. Breathing Spell for Debtor upon Filing

1. Timing of Approval of Certain Postpetition Financing Provisions

Recommended Principles:

- A court should not approve any proposed post-petition financing under section 364 of the Bankruptcy Code that (i) is subject to milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions within 60 days after the petition date or date of the order for relief, whichever is later, or (ii) otherwise conflict with another section of the Bankruptcy Code.
- In this context, the phrase "milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions" refers to tasks or conditions that relate in a material or significant way to the debtor's operations during the chapter 11 case or to the resolution of the case, including deadlines by which the debtor must conduct an auction, close a sale, or file a disclosure statement and a chapter 11 plan. It does not include payment of scheduled loan amounts, customary loan covenants, reporting requirements, ministerial tasks, or the debtor's compliance with a budget, provided that the budget does not impose disguised milestones or benchmarks.
- A court should not approve permissible extraordinary financing provisions in connection with any proposed post-petition financing under section 364 in any interim order.
- In this context, "permissible extraordinary financing provisions" include:

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[306] The Commission's discussion of the use and approval of provisions in a post-petition facility that may impact the course of the chapter 11 case or implement waivers of, or otherwise affect, rights under the Bankruptcy Code is set forth in Section IV.C.1, *Timing of Approval of Certain Post-petition Financing Provisions*; Section VI.C.3, *Section 506(c) and Charges Against Collateral*; and Section VI.C.4, *Section 552(b) and Equities of the Case*.

(i) milestones, benchmarks, or other provisions that require the trustee to perform certain tasks or satisfy certain conditions; (ii) representations regarding the validity or extent of the creditor's liens on the debtor's property or property of the estate; or

(iii) if some or all of the proposed post-petition lenders hold pre-petition debt that would be affected by the post-petition facility, a provision that refinances pre-petition debt with proceeds of the post-petition facility that is otherwise permissible under the principles relating to post-petition financing terms. See Section IV.B.2, *Terms of Post-petition Financing*.

- For the recommended principles on section 506(c) and section 552(b), see Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.4, *Section 552(b) and Equities of the Case*.

a. Timing of Approval of Certain Post-petition Financing Provisions: Background

Although an often necessary and critical source of post-petition liquidity, the post-petition facility negotiated between a debtor and its post-petition lenders may be subject to terms that could affect the chapter 11 case. For example, the terms of the proposed post-petition financing may require the debtor in possession[307] to pursue a sale process under section 363 of the Bankruptcy Code on an expedited basis; may set certain deadlines for the debtor to file its disclosure statement and chapter 11 plan; may contain waivers of certain rights held by the debtor in possession under the Bankruptcy Code, such as the right to assert surcharges under section 506(c); or may exclude the application of certain other provisions of the Bankruptcy Code, such as the equities of the case exception under section 552(b). The facility may also be subject to provisions addressing the validity of any pre-petition liens of the lenders, granting a lien in chapter 5 avoidance actions and any recoveries thereon, and default or termination provisions tied to a variety of developments in the particular chapter 11 case, such as motions for relief from the automatic stay or challenges to the liens held by post-petition lenders.

Bankruptcy Rule 4001(c)(1)(B) requires the debtor in possession to provide a "concise statement" that "lists or summarizes . . . all material provisions of the proposed credit agreement and form of order, including interest rate, maturity, events of default, liens, borrowing limits, and borrowing conditions." In addition, many jurisdictions supplement this requirement in their local rules with, among other things, provisions that require additional disclosures and limit the effect and extent of interim orders.[308] Bankruptcy Rule 4001(c)(2) requires the debtor in possession to provide at least 14 days' notice of the court's final hearing on a motion to obtain post-petition financing; however, many cases involve an interim hearing and the entry of an interim order shortly after the petition date and then a final hearing and the entry of a final order only after the statutory committee of unsecured creditors has been appointed and has had an opportunity to review and respond to the debtor's motion for the requested relief.

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[307] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[308] *See, e.g.*, Southern District of New York Bankruptcy Court Local Rule 4001-2.

b. Timing of Approval of Certain Post-petition Financing Provisions: Recommendations and Findings

The Commissioners discussed at length the potential impact of terms in a post-petition credit agreement that dictate or attempt to influence the course of the chapter 11 case, or that implement waivers of, or otherwise affect, rights under the Bankruptcy Code.[309] The Commissioners identified a variety of provisions that may fall into this category, including (i) milestones and benchmarks that require the debtor to take certain actions or satisfy certain conditions by deadlines set forth in the post-petition financing documents; (ii) concessions regarding the validity or enforceability of pre-petition liens; (iii) deadlines by which the debtor must conduct an auction, close a sale, or file a disclosure statement and chapter 11 plan; and (iv) waivers of, or stipulations concerning, the section 506(c) surcharge and the section 552(b) equities of the case exception.[310] Although Bankruptcy Rule 4001(c) requires the debtor to summarize these kinds of provisions, parties in interest may not have sufficient time or information to accurately assess the import of such provisions and the impact they may have on the case. Notably, the data compiled by the LSTA included information concerning post-petition financing with the following kinds of milestones or benchmarks: "Milestone re Bidding Procedures Orders," "Milestone re Sale Orders," "Milestone re Closing a Sale," and "Conditions for the Bidding Process for a 363 Sale."[311] A review of the 112 observations in the LSTA dataset with post-petition financing agreements (112 of 167 total sample) revealed that a post-petition facility subject to certain milestones or benchmarks in the chapter 11 case actually produced the required result — i.e., post-petition credit agreements that required a section 363 sale resulted in a section 363 sale, and post-petition credit agreements that required the filing of a plan resulted in a

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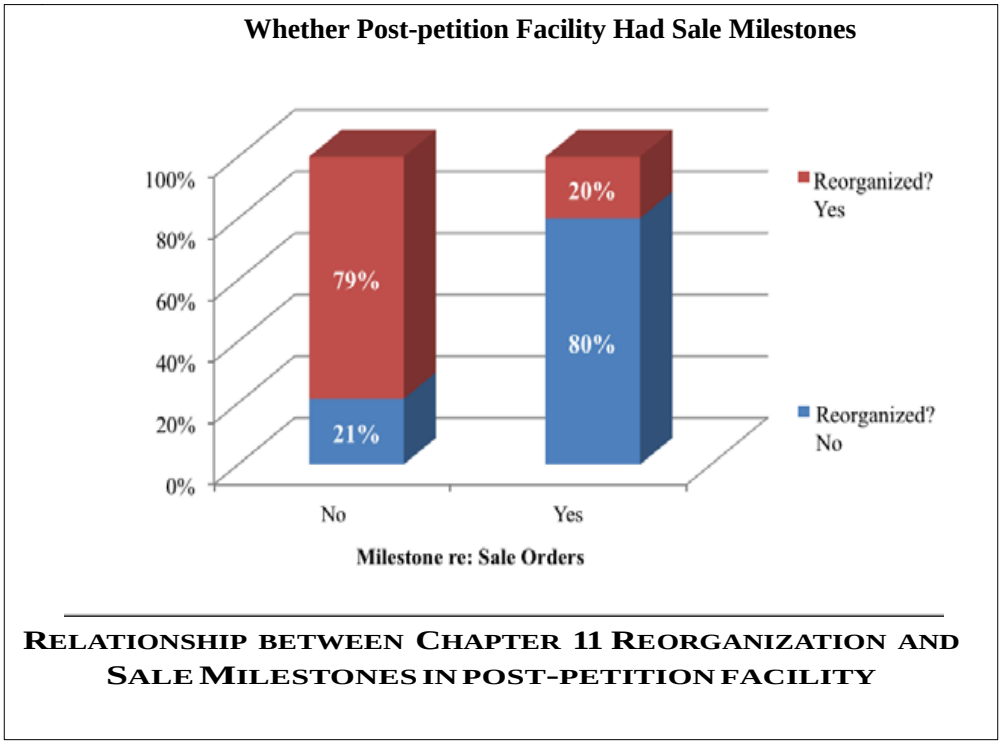
[309] *See Written Statement of Kathryn Coleman, Attorney at Hughes Hubbard & Reed, LLP: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–7 (Nov. 3, 2012), (describing how onerous the conditions of post-petition financing can be, including use of provisions that require a section 363 sale within 60 days of the lending date), *available at* Commission website, *supra* note 55; *Written Statement of Lawrence Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (June 4, 2013) (discussing how prepetition secured lenders of retail debtors demand post-petition financing provisions that result in quick liquidation sales), *available at* Commission website, *supra* note 55; W*ritten Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (June 4, 2013) (describing how restrictive DIP lending conditions prevent retail debtors from reorganizing), *available at* Commission website, *supra* note 55; *Written Statement of David L. Pollack, Partner, Ballard Spahr LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (June 4, 2013) (describing how post-petition financing terms have prevented retail reorganizations), *available at* Commission website, *supra* note 55.

[310] The Commission addressed this latter category in Section VI.C.3, *Section 506(c) and Charges Against Collateral* and in Section VI.C.4, *Section 552(b) and Equities of the Case*.

[311] These milestones are defined as follows: Milestone re Bidding Procedures Orders: If there was DIP Financing, was it an event of default not to have an order approving the bidding procedures for a sale of substantially all of the debtor's assets entered by a certain date? Yes/No. Milestone re Sale Orders: If there was DIP Financing, was it an event of default not to have an order approving a sale of substantially all of the debtor's assets entered by a certain date? Yes/No. Milestone re Closing a Sale: If there was DIP Financing, was it an event of default not to [close a sale] by a certain date? Yes/No. Conditions for the Bidding Process for a 363 Sale: If there as a DIP Financing, did it the process under which any auction of the debtor's assets had to occur? Yes/No. *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at Exhibit A p.4 (Nov. 30, 2012), *available at* Commission website, *supra* note 55.

confirmed plan.[312] Moreover, post-petition financing facilities with sale-oriented milestones were significantly less likely to result in a reorganization, as shown in the table below.[313]



RELATIONSHIP BETWEEN CHAPTER 11 REORGANIZATION AND SALE MILESTONES IN POST-PETITION FACILITY

The Commissioners discussed ways to provide more effective notice of these kinds of provisions to the unsecured creditors' committee and other parties in interest in the debtor's chapter 11 case, and highlighted the need to provide these parties with sufficient time to review and vet such provisions. In light of the potentially significant impact of these provisions on chapter 11 outcomes, the Commission determined that

[312] Based on the LSTA dataset, if the post-petition financing agreement contained a sale-related milestone or benchmark, the case was more likely to result in a sale or liquidation. This relationship was statistically significant at the 1.0 percent level. These analyses were performed using logistic regression, confirmed by the Chi Squared test, the Chi Squared Test with Yates Correction test, and the Likelihood Ratio test. These analyses were based on the data in Exhibit B to Mr. Shapiro's supplemental testimony. *Supplemental Written Statement of Mark Shapiro: ABI Winter Leadership Conference Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at Exhibit B (Nov. 30, 2012), *available at* Commission website, *supra* note 55. *See also Written Statement of Kathryn Coleman, Attorney at Hughes Hubbard & Reed, LLP: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 22 (Nov. 3, 2012) (stating that DIP lenders often require debtors to obtain the lenders' consent for any action outside the ordinary course of business, including filing a plan, and require the sale of the debtors' assets in a very short period of time, such as 60 days), *available at* Commission website, *supra* note 55. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[313] Mr. Roberts prepared this chart for the Commission based on data from the LSTA dataset.

such extraordinary provisions in post-petition facilities should be highlighted and clearly explained in the motion seeking approval of the post-petition financing. In addition, the Commission agreed that (i) such extraordinary provisions should not be subject to approval in an interim order, and (ii) milestones, benchmarks, or similar provisions should not be permitted to take effect until at least 60 days after the petition date.

2. Timing of Section 363x Sales

Recommended Principles:

- The trustee should not be permitted to conduct an auction of, or to receive final approval of a sale transaction involving, all or substantially all of the debtor's assets within 60 days after the petition date or date of the order for relief, whichever is later. The court should not shorten this 60-day moratorium unless (i) the trustee or a party in interest demonstrates by clear and convincing evidence that there is a high likelihood that the value of the debtor's assets will decrease significantly during such 60-day period, and (ii) the court finds that the proposed sale satisfies the standards set forth in the principles for section 363x sales. See Section VI.B, *Approval of Section 363x Sales*. For the purposes of this rule, the court may authorize a sale whether or not the secured creditor has requested or received adequate protection of its interests under section 361 of the Bankruptcy Code if the risk of decrease in the value of the debtor's assets is sufficient to warrant a sale before the expiration of the 60-day moratorium.

a. Timing of Section 363x Sales: Background

Section 363 of the Bankruptcy Code currently allows the trustee[314] to sell assets in the ordinary course of business as well as outside the ordinary course of business during the chapter 11 case.[315] A sale outside the ordinary course of business requires, among other things, notice and a hearing. It also typically requires an auction and public sale process.[316] Although courts frequently use the auction process as a means to ensure that

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[314] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[315] 11 U.S.C. § 363(b), (c).

[316] *See* Rachael M. Jackson, *Survey: Responding to Threats of Bankruptcy Abuse in a Post-Enron World: Trusting the Bankruptcy Judge as the Guardian of Debtor Estates*, 2005 Colum. Bus. L. Rev. 451, 469–70 (2005) ("The process of conducting an auction generally establishes that a successful bidder has paid the fair market value for the asset. Therefore, considering the tremendous emphasis that bankruptcy courts place on maximizing the value of the estate, auction sales are advisable because judges do not tend to scrutinize closely such transactions before approving the final sale. In addition, the security of an auction sale is enhanced because appellate courts review bankruptcy court confirmations with considerable deference and, therefore, disgruntled bidders are rarely successful in challenging a court-approved sale."); Brett Rappaport & Joni Green, *Calvinball Cannot Be Played on This Court: The Sanctity of Auction Procedures in Bankruptcy*, 11 Norton J. Bankr. L. & Prac. 189, 193 (2002) ("Public auctions are preferred over private auctions to ensure a market price, so that optimal return can be realized for creditors."); Philip A. Schovanec, *Bankruptcy: The Sale of Property Under Section 363: The Validity of Sales*

the assets are sold for the best and highest price, the plain language of section 363 and of the Bankruptcy Rules do not expressly require an auction and public sale process, and courts will, in certain instances, approve private sale transactions.

Courts also have long debated whether section 363 permits the sale of all or substantially all of a debtor's assets prior to the filing and confirmation of a chapter 11 plan.[317] The primary concerns of courts and commentators with this practice are premised on the absence of stakeholder protections that are otherwise incorporated into the section 1129 plan process: section 1125 requires meaningful disclosures; section 1126 requires a vote by holders of impaired claims and interests; section 1129 requires, among other things, that the plan (i) satisfy administrative and certain other claims against the estate; (ii) be in the best interests of creditors; and (iii) be accepted by all impaired classes of creditors, or have the support of at least one class of impaired creditors and be fair and equitable.[318] In addition, sales of all or substantially all of a debtor's assets on an expedited basis, particularly early in the chapter 11 case, can raise concerns about (a) the proper valuation and marketing of assets, (b) whether other restructuring alternatives were fully explored, and (c) whether the court, the U.S. Trustee, and stakeholders have sufficient information and time to review and comment on the proposed transaction.[319]

Courts have been increasingly willing to approve expedited sales of all or substantially all of a debtor's assets, provided that a debtor can demonstrate exigency and certain other showings. This section addresses the timing of such sales; the requirements for the approval of such sales are discussed below.[320] Prior to the early

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Conducted Without Proper Notice, 46 Okla. L. Rev. 489, 498 n. 63 (1993) ("While bankruptcy sales may be conducted privately, a public auction is usually held because competitive bidding ensures that fair and valuable consideration is received, thus helping to avoid any suspicion of collusion or impropriety.").

[317] The Second Circuit in *Lionel* examined this debate, as well as whether a sale of all or substantially all of a debtor's assets should be permitted absent an emergency situation. *In re Lionel Corp.*, 722 F.2d 1063, 1066 (2d Cir. 1983) (explaining, among other things, the history of section 363 sales, which the court traced to the Bankruptcy Act of 1867, and noting that under the 1867 Bankruptcy Act, "when it appears . . . that the estate of the debtor, or any part thereof, is of a perishable nature or liable to deteriorate in value, the court may order the same to be sold, in such manner as may be most expedient") (internal quotation marks omitted). The Second Circuit determined that such sales should be permitted but not without standards:

> Just as we reject the requirement that only an emergency permits the use of § 363(b), we also reject the view that § 363(b) grants the bankruptcy judge *carte blanche* . . . such construction of § 363(b) swallows up Chapter 11's safeguards. . . . [T]here must be some articulated business justification, other than appeasement of major creditors for using, selling or leasing property out of the ordinary course of business before the bankruptcy judge may order such disposition under 363(b).

Id. at 1069–70.

[318] 11 U.S.C. § 1129(a), (b).

[319] *See, e.g., In re* Fisker Auto. Holdings, Inc., 510 B.R. 55, 60–61 (Bankr. D. Del. 2014) ("It is the Court's view that Hybrid's rush to purchase and to persist in such effort is inconsistent with the notions of fairness in the bankruptcy process. The Fisker failure has damaged too many people, companies and taxpayers to permit Hybrid to short-circuit the bankruptcy process."); *In re* On-Site Sourcing, Inc., 412 B.R. 817, 824 (Bankr. E.D. Va. 2009) (listing the following nine areas of concern when analyzing a section 363 motion seeking expedited relief: (1) Is there evidence of a need for speed? (2) What is the business justification? (3) Is the case sufficiently mature to assure due process? (4) Is the proposed APA sufficiently straightforward to facilitate competitive bids or is the purchaser the only potential interested party? (5) Have the assets been aggressively marketed in an active market? (6) Are the fiduciaries that control the debtor truly disinterested? (7) Does the proposed sale include all of a debtor's assets and does it include the 'crown jewel'? (8) What extraordinary protections does the purchaser want? (9) How burdensome would it be to propose the sale as part of confirmation of a chapter 11 plan?) (citation omitted).

[320] *See* Section VI.B, *Approval of Section 363x Sales*.

2000s, a traditional chapter 11 sale process under section 363 could take at least three months, if not more.[321] This course typically involved a thorough post-petition marketing and auction process; sufficient opportunity for notice, objections, and hearings on both the auction process and sale transaction; and the closing of the sale.[322] This practice allowed the court, the debtor in possession, the U.S. Trustee, and parties in interest a full opportunity to consider the value of the assets and alternatives to a sale, instilled a certain level of confidence in the bankruptcy sale process, and resulted in the conclusion that the approved sale was in the best interests of the estate.

In recent years, the sale process has become much more abbreviated. Although the *General Motors* and *Chrysler*[323] chapter 11 cases — in each case a section 363 sale was completed in approximately 41 days — were more fast-paced than many cases, the average time between the petition date and the sale date has steadily decreased, as illustrated by the following chart.[324]

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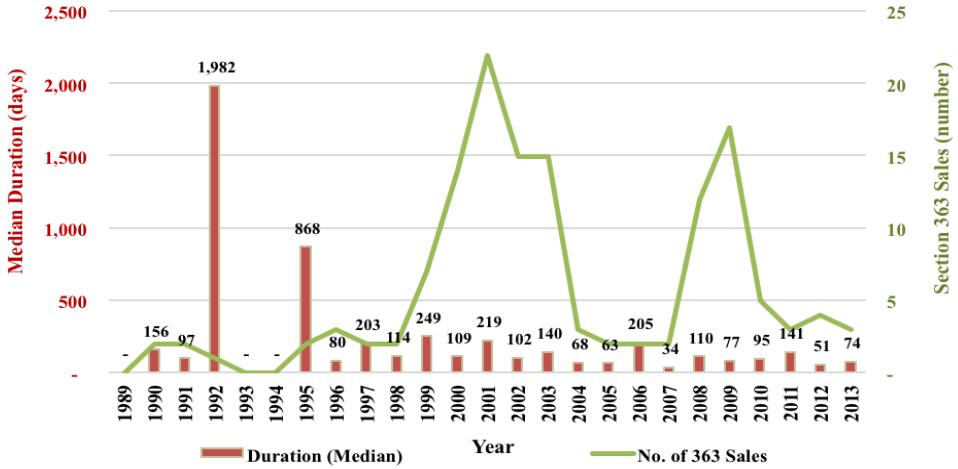
[321] Cases typically provided set deadlines for a meaningful auction process and then sufficient time for objections to, and a hearing on, the sale transaction itself. In addition, Bankruptcy Rule 2002(a)(2) requires 21 days' notice by mail of "a proposed use, sale or lease of property of the estate other than in the ordinary course of business, unless the court for cause shown shortens the time or directs another method of giving notice." Fed. R. Bankr. P. 2002(a)(2).

[322] For a general description of the steps required in a typical sale and auction process under section 363(b), *see, e.g.*, *In re* Adoption of Amended Guidelines for the Conduct of Asset Sales, General Order Amending M-331, M-383 (Bankr. S.D.N.Y. Nov. 18, 2009), *available at* http://www.nysb.uscourts.gov/sites/default/files/m383.pdf.

[323] *See, e.g.*, *In re* Gen. Motors Corp., 407 B.R. 463, 491–92 (Bankr. S.D.N.Y. 2009), *aff 'd sub nom. In re* Motors Liquidation Co., 430 B.R. 65 (S.D.N.Y. 2010); *In re* Chrysler LLC, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 592 F.3d 370 (2d Cir. 2010). *See also In re* Lehman Bros. Holdings Inc., Case No. 08-13555 (Bankr. S.D.N.Y 2008) (sale approved within seven days of petition date).

[324] Mr. Shrestha prepared this chart and table for the Commission based on data from the UCLA-LoPucki Bankruptcy Research Database. Accordingly, it was limited to large public companies. The duration above is the time between the petition date and the date of the sale order.



Note: In this bar chart above, the y-axis shows the number of days between the petition date and the date of the sale order for a sale of all or substantially all of the debtor's assets. The median number of days between the petition date and the sale order approving a section 363 sale has declined from a high of 1982 days in 1992 to 51 days in 2012. Notably, in some years, the data only show one (e.g., 1992) or just a few orders approving section 363 sales for substantially all of the debtor's assets. (These data may not have captured sales, for example, consummated through a plan of reorganization, which was coded separately in the dataset.) The table below identifies the number of section 363 sale orders per year, as well as the mean and median duration between the petition date and the sale order.

DURATION BETWEEN BANKRUPTCY FILING AND SECTION 363 SALE ORDER			
Year	**Mean No. of Days**	**Median No. of Days**	**No. of 363 Sales**
1989	-	-	
1990	156	156	2
1991	97	97	2
1992	1,982	1,982	1
1993	-	-	-
1994	-	-	-
1995	868	868	2
1996	127	80	3
1997	203	203	2
1998	114	114	2
1999	470	249	7
2000	137	109	14
2001	275	219	22

2002	287	102	15
2003	227	140	15
2004	72	68	3
2005	63	63	2
2006	205	205	2
2007	34	34	2
2008	187	110	12
2009	81	77	17
2010	134	95	5
2011	116	141	3
2012	63	51	4
2013	82	74	3

The speed with which section 363 sales are now approved and consummated causes some courts, stakeholders, and commentators to question whether value is being removed from the estate by permitting a value realization event such as a sale too early and too quickly in a chapter 11 case.[325] Many commentators recognize that there could be exceptions — true "melting ice cubes" that require immediate resolution to preserve any value for the estate — but those exceptions, they argue, should not define the rules.[326]

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[325] *See, e.g.*, Jessica Uziel, *Section 363(b) Restructuring Meets the Sound Business Purpose Test with Bite: An Opportunity to Rebalance the Competing Interests of Bankruptcy Law*, 159 U. Pa. L. Rev. 1189, 1214 (2011) ("Section 363 sales' expedited process and lesser disclosure requirements make investigation of the purchaser's behavior vital in order to protect creditors, equity security holders, and debtors from exploitation. Increased potential for abuse threatens creditors' interests as well as the debtor's ability to maximize the value of the estate."); Elizabeth B. Rose, *Chocolate, Flowers, and § 363(b): The Opportunity for Sweetheart Deals Without Chapter 11 Protections*, 23 Emory Bankr. Dev. J. 249, 272 (2006) ("Without comprehensive information available to the court and the committee the sale is vulnerable to sweetheart deals or unfair dealing."). *See generally* Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007) (comparing recoveries from bankruptcy sales of large corporations to those of bankruptcy reorganizations from 2000 to 2004). *But see Written Statement of Honorable Melanie Cyganowski (Ret.), former U.S. Chief Bankruptcy Judge, E.D.N.Y.: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Nov. 15, 2012) (asking the Commission not to impose a delayed time frame for section 363 sales), *available at* Commission website, *supra* note 55. "In the SMEs and middle-market cases, the Chapter 11 debtors have, in many instances, little flexibility, little bargaining power and even more minimal lines of credit. The Court needs in many instances to force a sale on very short notice . . . to maximize value for the estate." *Id. But see Written Statement of Robert D. Katz, Managing Director of Executive Sounding Board Associates Inc.: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–4 (Nov. 15, 2012) (asking the Commission not to impose a delayed time frame for section 363 sales), *available at* Commission website, *supra* note 55.

[326] A "melting ice cube" case refers to a case involving assets subject to rapid decline because of the nature of such assets (often referred to as "perishable" assets) or unique, exigent circumstances that cannot otherwise be avoided. For a general discussion of these cases and some of the challenges they pose, *see* Jacoby & Janger, *Ice Cube Bonds*, *supra* note 283. The challenge for most courts is that bankruptcy by its nature often is an emergency procedure, so articulating a need to sell today as opposed to tomorrow is easy; assessing the validity of that assertion is not. *See, e.g., In re* Humboldt Creamery, LLC, 2009 WL 2820610, at *2 (Bankr. N.D. Cal. Aug. 14, 2009) ("[T]he problem with the 'melting ice cube' argument is that it is easy enough for the debtor to unplug the freezer prior to bankruptcy."); *In re* Gulf Coast Oil Corp., 404 B.R. 407, 423 (Bankr. S.D. Tex. 2009) ("The Court must be concerned about a slippery slope. Not every sale is an emergency, and, as discussed more fully below, the

b. Timing of Section 363x Sales: Recommendations and Findings

The Commissioners examined the process relating to a sale of all or substantially all of a debtor's assets (referred to as a "section 363x sale" in these principles) at great length. In addition to reconsidering the standard of review and substantive requirements for section 363x sales, the Commission also scrutinized the timing issues surrounding these sales.

The Commissioners discussed the potential benefits to a quick sale — e.g., potentially less time in chapter 11; potentially less expensive reorganization strategy; typically preferred by post-petition lenders and pre-petition secured creditors because of faster payoff; and typically preferred by stalking-horse bidders because a quick sale disfavors outside bidders.[327] The Commission also recognized that if a debtor's business assets are of a perishable nature or otherwise subject to a rapid decline in value, then a quick sale may be the best and perhaps only option for maximizing value for the estate and its stakeholders.

The Commission generally agreed, however, that section 363x sales are proceeding more quickly than is necessary in many chapter 11 cases. The Commissioners noted that quicker than necessary sales can potentially reduce the value available for stakeholders in the chapter 11 case. Such a sale may (i) not facilitate a robust auction, (ii) not allow the debtor sufficient time to explore a stand alone reorganization or other restructuring alternatives, and (iii) take advantage of a decline in the applicable markets without giving parties in interest a reasonable time to assess the likelihood that such markets will rebound during the pendency of the debtor's chapter 11 case. The Commissioners also acknowledged the problems with insufficient notice and opportunity for parties in interest to assert meaningful objections or perform reliable asset valuations within the abbreviated time frames of a quick sale.

After extensive deliberation, the Commission found that in many cases, the potential harm to the estate from a sale that is pushed through the process more quickly than necessary under the circumstances significantly outweighs any potential benefits of such a sale. Accordingly, the Commission agreed that the Bankruptcy Code should include a 60-day moratorium on section 363x sales, absent the most extraordinary of circumstances, which must be established by clear and convincing evidence at the hearing on the motion requesting an expedited sale process.

D. Payment of Certain Claims upon Filing

When a debtor files a chapter 11 case, the automatic stay of section 362 of the Bankruptcy Code prohibits the debtor in possession from paying any pre-petition claims

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reliability of uncontested evidence (and particularly the reliability of testimony that is not adequately cross-examined) is suspect.").

[327] *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 5 (Nov. 15, 2012) ("CFA submits that promoting an efficient sale of collateral to a purchaser who is able to continue to use those assets in a productive form is good for the economy in general and for the selling debtor's stakeholders in particular."), *available at* Commission website, *supra* note 55.

outside the chapter 11 plan or without prior approval of the court. A key factor underlying this prohibition is that sections 507 and 1129 of the Bankruptcy Code incorporate a fairly stringent priority scheme for the payment of pre-petition claims. Payments outside the chapter 11 plan may result in an unfair allocation of value among stakeholders in the chapter 11 case.

Nevertheless, a debtor in possession strives to achieve a soft landing in chapter 11, which requires the continuation of "business as usual" to the greatest extent possible. A debtor in possession thus frequently requests court authorization to pay certain pre-petition claims that are asserted to be either necessary to the ongoing operations of the business or are consistent with the priority rules set forth in section 507.

1. Prepetition Claims and the Doctrine of Necessity

Recommended Principles:

- The court should have the authority to enter an order permitting the payment of certain pre-petition claims when such remedy is directed toward: (i) employee wages or other compensation; or (ii) claims for vendor goods or services for which the trustee establishes an evidentiary record supporting such extraordinary relief, provided that any such relief should not include claims for the kinds of goods covered by section 503(b)(9) of the Bankruptcy Code unless the court finds some relief is compelled for a particular kind of good by applicable nonbankruptcy law that is not otherwise preempted by the Bankruptcy Code and is not deemed a disguised priority.
- For a discussion of section 503(b)(9), see Section V.E.1, *Section 503(b)(9) and Reclamation*.

a. Prepetition Claims and the Doctrine of Necessity: Background

The doctrine of necessity originates from the early railroad equity receivership cases.[328] In those cases, courts generally granted priority status to the railroad's current operating expenses that were incurred within six months of the filing and were deemed necessary to keep the railways and interstate commerce moving.[329] Although not expressly authorized by the Bankruptcy Code, courts have continued to invoke the doctrine of necessity[330] in certain circumstances under the court's general equitable powers set forth in section 105(a) of the Bankruptcy Code.[331]

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[328] *See, e.g.*, Miltenberger v. Logansport, 106 U.S. 286 (1882), *superseded by statute*, Bankruptcy Act of 1898, *as recognized in In re* Kmart Corp., 359 F.3d 866, 871 (7th Cir. 2004), *cert. denied*, 543 U.S. 986 (2004) (payment of pre-receivership claims to prevent interruption in business).

[329] *Id.*

[330] *See, e.g.*, *In re* Just For Feet, Inc., 242 B.R. 821, 826 (D. Del. 1999); *In re* NVR L.P., 147 B.R. 126, 128 (Bankr. E.D. Va. 1992); *In re* Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991); *In re* Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989).

[331] Section 105(a) provides:

> The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from . . . taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

Debtors in possession[332] commonly rely on the doctrine of necessity and the court's equitable powers when requesting authority to pay pre-petition claims outside the chapter 11 plan. One type of claim that a debtor in possession seeks to pay is the so-called "critical vendor" claim. "Critical vendors" are commonly defined as essential vendors or suppliers who are indispensable to the debtor's business — either because of the types of goods or services they supply, their knowledge of the debtor's business, or some other unique aspect to the business relationship — and without whom the debtor likely cannot achieve a successful reorganization.[333] A debtor's request typically will propose conditions for the payment of these claims, such as percentage payments and an agreement that the vendor or supplier will continue with the debtor on the same terms as their pre-petition agreement. Courts authorizing the payment of critical vendor claims generally rely on the doctrine of necessity and section 105(a).[334] Notably, not all courts agree that the doctrine of necessity and section 105(a) can be used for these purposes.[335]

b. Prepetition Claims and the Doctrine of Necessity: Recommendations and Findings

Whether the Bankruptcy Code should condone the early or priority payment of the pre-petition claims of certain "critical vendors" may be influenced by the Bankruptcy Code's treatment of certain vendor claims as "administrative claims" under section 503(b)(9). The Commission separately analyzed the treatment of vendor claims under section 503(b)(9).[336] As discussed below, the Commission recommended the continued application of section 503(b)(9). In making this recommendation, however, the Commission also determined that section 503(b)(9) should be the sole remedy available to creditors who are deemed eligible to receive early or priority payment on their pre-petition claims against the debtor.

The Commission reviewed justifications most commonly articulated to support critical vendor payments. These include a debtor's need to: (i) continue to receive a steady supply of goods and services required for the operation of the debtor's business; (ii) appease creditors who threaten to discontinue supply or services without payment;

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11 U.S.C. § 105(a). Notably, some courts have found or suggested authority to authorize the payment of critical vendor claims under section 363(b) of the Bankruptcy Code. *See, e.g., In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004), *cert. denied*, 543 U.S. 986 (2004); *In re* Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989).

[332] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[333] *See, e.g., In re* Just For Feet, Inc., 242 B.R. 821 (D. Del. 1999).

[334] Courts continued to use the doctrine in connection with their authority under section 105 to authorize, among other things, payments deemed necessary to the debtor's reorganization efforts. *See, e.g., In re* Just For Feet, Inc., 242 B.R. 821, 826 (D. Del. 1999); *In re* NVR L.P., 147 B.R. 126, 128 (Bankr. E.D. Va. 1992); *In re* Eagle-Picher Indus., Inc., 124 B.R. 1021, 1023 (Bankr. S.D. Ohio 1991); *In re* Ionosphere Clubs, Inc., 98 B.R. 174 (Bankr. S.D.N.Y. 1989).

[335] For courts rejecting the use of section 105 and the doctrine of necessity to authorize the payment of prepetition claims, see, *e.g.*, *In re* Kmart Corp., 359 F.3d 866 (7th Cir. 2004), *cert. denied*, 543 U.S. 986 (2004); Chiasson v. J. Louis Matherne & Assocs. (*In re* Oxford Mgmt., Inc.), 4 F.3d 1329 (5th Cir. 1993); Official Comm. of Equity Sec. Holders v. Mabey, 832 F.2d 299 (4th Cir. 1987), *cert. denied*, 485 U.S. 962 (1988); B&W Enters., Inc. v. Goodman Oil Co. (*In re* B&W Enters., Inc.), 713 F.2d 534 (9th Cir. 1983).

[336] *See* Section V.E.1, *Section 503(b)(9) and Reclamation*.

(iii) obtain products from a single-source supplier; (iv) comply with applicable state or other nonbankruptcy law that requires performance on a contract and is not otherwise preempted by the Bankruptcy Code; and (v) make payments that may be necessary for the survival of a key vendor.[337] The Commissioners noted the danger of viewing these needs in isolation without considering the rights of other stakeholders and commonly applied protections of the Bankruptcy Code, such as the automatic stay in section 362.

Although the Commissioners generally understood the potential hardship imposed on certain vendors by the automatic stay and the nonpayment of pre-petition claims, some of the Commissioners observed that critical vendors are not substantively distinguishable from other pre-petition creditors and should therefore be similarly situated. These Commissioners warned against the dangers of diluting various protections provided by the Bankruptcy Code that were originally intended to allow a debtor to catch its financial breath, assess its financial and operational condition under the protection of the automatic stay, and develop a plan that would treat all similarly situated creditors alike.[338] The increasing categories of priority claims have reduced the debtor's discretionary cash resources and made priority payments the rule rather than the limited exception they were intended to be.

The Commission decided to recommend that the Bankruptcy Code specifically authorize the payment of pre-petition claims to vendors for goods and services in certain instances, provided that such vendors are not eligible for administrative priority under section 503(b)(9). (As discussed in the context of section 503(b)(9), the Commissioners found that the priority afforded to vendor claims under section 503(b)(9) should provide sufficient protection and incentive for vendors to continue doing business with the debtor in possession.) In reaching its conclusion, the Commission recognized that certain vendors may in fact be indispensable to the debtor's reorganization but not be eligible for section 503(b)(9) treatment and unable to perform without some compromise and payment of their pre-petition claims. The Commission determined, however, that the standard should be stringent and require evidence to

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[337] *See, e.g.,* J.M. Blanco, Inc. v. PMC Mktg. Corp., 2009 WL 5184458, at *2 (D.P.R. Dec. 22, 2009) (debtor offered evidence to support that critical vendor supplied "merchandise [that] was critical and that no other vendor was available to offer the same inventory under equal terms and conditions"); *In re* Tropical Sportswear Int'l Corp., 320 B.R. 15, 20 (Bankr. M.D. Fla. 2005) ("This Court finds that the Debtors' situation with its Critical Vendors is precisely the situation where critical vendor status is warranted. Each of the four Critical Vendors is a major supplier of specialty goods or services to the Debtors, and any interruption in the flow of their products to the Debtors would substantially jeopardize the Debtors' ability to conduct business. As such, the Critical Vendors are absolutely critical to the maintenance of the Debtors' estates."). *See also* Joseph Gilday, *"Critical" Error: Why Essential Vendor Payments Violate the Bankruptcy Code*, 11 Am. Bankr. Inst. L. Rev. 411, 416 (2003) ("Debtor's counsel usually claims that losing such services or products would have, in the words of one, a 'severely pernicious effect on [its] efforts to rehabilitate and reorganize.' The inability to operate its business as it normally does would decrease the debtor's cash flow and cripple its operations before it had a chance to propose a reorganization plan, according to its counsel.") (citations omitted).

[338] *See* Mason v. Official Comm. of Unsecured Creditors (*In re* FBI Distrib. Corp.), 330 F.3d 36, 41–42 (1st Cir. 2003) ("[T]he fundamental principle of bankruptcy law [is] that the debtor's limited resources are to be distributed equally among similarly situated creditors [so] . . . statutory priorities are narrowly construed. . . ."); *In re* Mirant Corp., 296 B.R. 427, 429 (Bankr. N.D. Tex. 2003) ("[T]his court has reservations about granting such relief [to critical vendors] when to do so could result in certain favored unsecured creditors receiving treatment preferential to that received by other unsecured creditors under a plan."); *In re* Structurlite Plastics Corp., 86 B.R. 922, 932 (Bankr. S.D. Ohio 1988) ("[R]e-payment of pre-petition debt should not be authorized as a result of threats or coercion by disgruntled creditors. Such activity violates the automatic stay imposed by 11 U.S.C. § 362(a) and, if tolerated, would negate the fundamental principle of equality of treatment among similarly situated creditors.").

establish why, for example, the debtor cannot obtain the particular services from another source, the state law obligation is not preempted by the Bankruptcy Code, or the state law obligation is not otherwise deemed an impermissible disguised priority. The Commission agreed that clarifying the court's ability to authorize the payment of pre-petition vendor claims under the Bankruptcy Code would reduce uncertainty and litigation, as well as the related costs, for the estate and creditors.

In the context of pre-petition vendor claims for goods, the Commission considered instances in which state law might prohibit a nondebtor party from providing goods to a debtor that has not paid a vendor's invoices. The Commissioners analyzed whether the Bankruptcy Code needed to provide the court and the debtor in possession some flexibility in this context to preserve the business. In so doing, the Commissioners discussed the federal preemption doctrine, which is rooted in the Supremacy Clause of the U.S. Constitution,[339] and its well-established application to override state bankruptcy laws that interfere with federal bankruptcy law.[340] The distributional requirements and priority rules under Bankruptcy Code section 507 therefore preempt any contrary state laws that seek to grant priority to certain claims.[341] For example, Bankruptcy Code section 545 was enacted specifically to preempt statutory liens that are not good against a bona fide purchaser under state law.[342] The Commissioners analyzed these concepts in trying to balance a debtor in possession's need to satisfy a

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[339] U.S. Const. art. VI, ¶ 2 ("This Constitution, and the laws of the United States which shall be made in pursuance thereof; and all treaties made, or which shall be made, under the authority of the United States, shall be the supreme law of the land; and the judges in every state shall be bound thereby, anything in the Constitution or laws of any State to the contrary notwithstanding.").

[340] Stellwagen v. Clum, 245 U.S. 605, 613 (1918) ("In view of this grant of authority [over bankruptcy] to the Congress it has been settled from an early date that state laws to the extent that they conflict with the laws of Congress, enacted under its constitutional authority, on the subject of bankruptcies are suspended.").

[341] "Under the Supremacy Clause, U.S. Const. Art. VI, contrary provisions of state law must give way before the distributional requirements of the Bankruptcy Act [predecessor to the Bankruptcy Code]." *In re* Faber's, Inc., 360 F. Supp. 946, 949 (D. Conn. 1973). *See, e.g.*, Int'l Bhd. of Teamsters, AFL-CIO v. Kitty Hawk Int'l, Inc. (*In re* Kitty Hawk, Inc.), 255 B.R. 428, 439 (Bankr. N.D. Tex. 2000) ("Although the nature of a creditor's claim is determined under state law, the [Bankruptcy] Code establishes the priorities of claims. . . . Where a state statute would alter the priority of claims in a bankruptcy case, the state statute is pre empted by the Code.") (holding that Michigan statute providing employees with a preference over other general unsecured creditors is preempted by Bankruptcy Code sections 507 and 1113); *In re* Lull Corp., 162 B.R. 234, 240 (Bankr. D. Minn. 1993) ("A state statute cannot reset bankruptcy priorities.") (holding that Minnesota statute allowing workers' compensation fund to have the same priority accorded to employee wages is preempted by section 507).

[342] Section 545 provides, in relevant part, that "[t]he trustee may avoid the fixing of a statutory lien on property of the debtor" under certain conditions. 11 U.S.C. § 545. One bankruptcy court explained that the provisions from which section 545 derived were "intended to prevent state laws which prioritized liens on the happening of insolvency from undercutting federal bankruptcy laws." Davis v. IRS, 22 B.R. 523, 525 (Bankr. W.D. Pa. 1981). For cases upholding state law provisions under section 545, *see In re* Merchs. Grain, Inc., 93 F.3d 1347, 1358 (7th Cir. 1996), *cert. denied*, 519 U.S. 1111 (1997) (Ohio statute creating lien upon delivery of grain is not avoidable under section 545); *In re* Anchorage Int'l Inn, Inc., 718 F.2d 1446, 1452 (9th Cir. 1983) (Alaska statute requiring proceeds of sale of a liquor license to be used first to pay creditors holding debts related to the liquor licensed business creates valid lien); *In re* Nicolls, 384 B.R. 113, 122 (Bankr. W.D. Pa. 2008) (Indiana statute creating hospital lien in favor of patient with judgment against tortfeasor for injuries requiring medical case creates valid lien). For cases striking down and refusing to enforce state law provisions, *see* Perez v. Campbell, 402 U.S. 637, 652 (1971) (Arizona statute that suspended driving privileges unless, among other things, motorist subject to judgment posted security sufficient to satisfy judgment, even if judgment claim was discharged in bankruptcy is invalid); *In re* Universal Trend, Inc., 114 B.R. 936, 938 (Bankr. N.D. Ohio 1990) (Ohio statute that establishes statutory trust in favor of employees is preempted by employees' bankruptcy rights and thus invalid, and does not prevent any such trust funds from being withheld as property of the estate).

nonbankruptcy law requirement that was not a disguised priority in order to continue its business operations and the general restraints of the doctrine of necessity and federal bankruptcy priorities. In striking this balance with respect to state laws applicable to vendor goods, the Commission articulated a standard similar to that imposed by courts under section 545: courts should not authorize payment of pre-petition claims that become due upon the debtor's insolvent financial condition or the commencement of the debtor's bankruptcy case, or have no legitimate purpose outside the bankruptcy context.[343]

The Commission did not address or recommend codification of standards to allow the payment of other pre-petition claims that may be permissible under current bankruptcy law and the doctrine of necessity. Rather, other than the two categories of claims specifically addressed in the recommended principles, the Commission determined that such claims should continue to be governed by current law.

2. Wage and Benefits Priorities

Recommended Principles:

- Section 507(a)(4) and (5) of the Bankruptcy Code should be combined to create a single priority in an aggregate amount of $25,000 per employee, without an earnings period limit, for the kinds of pre-petition employee compensation and benefit plan claims identified in the current section 507(a)(4) and (5). To the extent that the aggregate limit is insufficient to meet all such obligations, the current pre-petition priority order — wages and other compensation as identified in section 507(a)(4), followed by employee benefit plan contributions as described in section 507(a)(5) — should continue to be observed in applying the combined, aggregate priority. As under current law, the amount of this aggregate per-employee priority should be increased based on the Consumer Price Index for All Urban Consumers under section 104(a).
- In addition, section 549 should be amended to permit the trustee to pay pre-petition employee wages, other compensation, and benefit plan contributions up to the per-employee priority limit without requiring the filing of a motion or order of the court, although the trustee should provide notice of such payments to be made. Authority for payments in excess of the priority cap should continue to be requested by motion.

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[343] One court explained that to withstand scrutiny, "the state law must attend to the realities and technicalities of the property rights created, or else those rights will be dismissed as disguised priorities under the Bankruptcy Code." *In re* Universal Trend, Inc., 114 B.R. 936, 938 (Bankr. N.D. Ohio 1990) ("The Bankruptcy Code often takes account of property rights which are determined by state law, as for example, the perfection of security interests and exempt property of the Debtor. Nonetheless, the state law must attend to the realities and technicalities of the property rights created, or else those rights will be dismissed as disguised priorities under the Bankruptcy Code.") (quoting *In re* Davis, 13 B.R. 456, 460 (Bankr. S.D. Ohio 1980)). "Statutory enactments may operate to create trust funds in favor of certain specified persons. . . . However, such trusts must stand the tests of being termed disguised priorities in violation of section 507 or statutory liens avoidable under section 545." *Id.* at 940 (citations omitted). *See also In re* Anchorage Int'l Inn, Inc., 718 F.2d 1446, 1450 n. 3 (9th Cir. 1983) ("[W]hen a state-created entitlement is enforceable inside and outside bankruptcy, 'there is no reason stemming from the justifications underlying condemnation of state-created priorities . . . to refuse recognition of the entitlement' in the bankruptcy situation.") (citations omitted).

a. Wage and Benefits Priorities: Background

Employees are the heart of many businesses. They make the debtor's product, service its customers, and innovate, manage, and generate value. Although some commentators view employees as liabilities, in many industries, the success of a business often relates directly to the commitment and efforts of its employees.

Employees, in turn, frequently depend on timely payments from their employers for their livelihood and subsistence. As observed by one court: "The bankruptcy act, while primarily intended to secure an equal distribution of the assets of the bankrupt among his creditors, evinces a strong intent on the part of Congress to protect those who are dependent on their daily earnings for their support."[344] In this respect, employees arguably differ from other creditors who either may have other revenue sources in addition to payments owed and made by the debtor, or may have a greater capacity to perform diligence on the debtor to negotiate for stronger contractual protections and leverage.[345] Priority treatment for wage claims under U.S. bankruptcy laws has a long history.[346] Their priority was clearly articulated in the short-lived 1841 Act, and was included and refined in the laws that followed. Such priority was initially limited to certain kinds of employees, but more recent laws have focused on limiting this priority based on (i) when the wages were earned and (ii) the amount of wages earned.[347]

The Bankruptcy Code has continued this model in two sections: section 507(a)(4) provides a priority for wages and other compensation up to $11,725 per employee earned by the employee during 180 days before the earlier of the petition date or the date of the cessation of the debtor's business; and section 507(a)(5) provides a priority for employer contributions to employee benefit plans for services provided during 180 days before the earlier of the petition date or the date of the cessation of the debtor's business in an aggregate amount of $11,725, multiplied by the number of covered employees less any amounts paid to such employees under section 507(a)(4).

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[344] *See In re* Caldwell, 164 F. 515 (E.D. Ark. 1908).

[345] *See* Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 Yale L.J. 857, 885 (1996); Elizabeth Warren & Jay Lawrence Westbrook, *Contracting Out of Bankruptcy: An Empirical Intervention*, 118 Harv. L. Rev. 1197, 1232 (2005). Professors Warren and Westbrook explain:

> The substantial sophistication and the high transaction costs required to obtain the necessary information present significant barriers. Moreover, the costs of moving from one employer to another can be quite onerous. . . . Similarly, although most creditors have the option of spreading their risks by extending credit to several customers, this option is not available to employees, who are unlikely to work for more than a single employer.

Id.

[346] *See Ex Parte* Steiner, 22 F. Cas. 1234 (C.C.E.D. Pa. 1842) (No. 13,354) (interpreting wage priority under the 1841 Bankruptcy Act).

[347] For example, section 64(b) of the 1898 Bankruptcy Act provided fourth priority to "wages due to workmen, clerks, or servants which have been earned within three months before the date of the commencement of proceedings, not to exceed three hundred dollars to each claimant." Bankruptcy Act of 1898, 30 Stat. 544, 563, c. 541 (Comp. St. § 9648).

b. Wage and Benefits Priorities: Recommendations and Findings

Congress added section 507(a)(5) to address a split in the case law about whether the "wage" priority covered contributions to certain kinds of employee benefit plans.[348] The language of section 507(a)(5) clarified this point, but courts, debtors, and employees have continued to struggle with the application of section 507(a)(4) and (5) priorities. Common issues include: (i) whether the section 507(a)(5) priority imposes an aggregate or per-employee cap,[349] and (ii) whether the mandatory offset of the section 507(a)(4) "wage priority" against the section 507(a)(5) "benefit plan priority" results in often inadequate protection for the employee. The latter issue also causes calculation and administrative issues for debtors and, perhaps more importantly, substantial hardship for many employees.

The Commissioners articulated various ways to restructure the wage and employee benefits priorities. As a conceptual matter, the Commission determined that one overall monetary cap covering both wages and employee benefit plan contributions on a per-employee basis was consistent with the historical development of these priorities and achieved a fair result. It also determined that the base aggregate cap should be raised to $25,000 per employee, with that amount being applied first toward wage claims and second toward employee benefit plan contributions, in the event that such cap is insufficient to satisfy all covered claims.

Finally, the Commissioners discussed the common practice by debtors in possession[350] of filing a first-day motion requesting authority to pay employee wages and benefit plan contribution claims, typically on the ground that such claims are entitled to priority treatment under section 507. Such motions and the attendant responsive pleadings, hearings, and orders unnecessarily consume both debtor and judicial resources and can delay the debtors' normal payroll cycles, even though these motions are often noncontroversial and ultimately granted by the court. Many courts, debtors, and commentators recognize the value to the debtor of receiving uninterrupted service from its employees. Accordingly, the Commission recommended that section 549 of the Bankruptcy Code be amended to allow the debtor in possession to pay wage priority and benefit plan priority claims up to the proposed per-employee priority cap, pursuant to section 507(a)(4) and (5) without an order of the court, provided that the debtor files a notice of the amount of such proposed payments.

E. Financial Contracts, Derivatives and Safe Harbor Provisions

The filing of a chapter 11 case typically effects an automatic stay of, among other things, all pre-petition collection efforts against the debtor, its property, and property of

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[348] *See, e.g.*, Howard Delivery Serv., Inc. v. Zurich Am. Ins. Co., 547 U.S. 651, 658–60 (2006).

[349] *See In re* Consol. Freightways Corp. of Del., 363 B.R. 110, 123 (Bankr. C.D. Cal. 2007), *aff 'd in part, rev'd in part*, 564 F.3d 1161 (9th Cir. 2009) (discussing different approaches to calculating the section 507(a)(5) priority cap).

[350] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

the estate.[351] In addition, counterparties to many pre-petition executory contracts with the debtor cannot unilaterally terminate their contracts or otherwise affect the debtor's rights under such contracts, and the trustee may avoid pre-petition fraudulent and preferential transfers.[352] The Bankruptcy Code, however, exempts certain kinds of financial contracts from these and certain other bankruptcy provisions. These exemptions generally cover financial contracts qualifying as a securities contract, commodities contract, forward contract, repurchase agreement, swap agreement, or master netting agreement (collectively referred to as "qualified financial contracts").[353]

The protections under the Bankruptcy Code for qualified financial contracts — commonly referred to as "safe harbors" — find their origins in sections 362(b)(6) and 746(c) of the Bankruptcy Code, which were both included in the 1978 version of the Bankruptcy Code to promote stability in the commodities market.[354] Congress built on this concept in 1982 by adding certain kinds of securities contracts to the exemptions and enhancing the protections afforded to those contracts (it also replaced section 746(c) with section 546(e)).[355] Similar to the original legislation, Congress identified market stability as the primary purpose underlying these amendments: "[C]ertain protections are necessary to prevent the insolvency of one commodity or securities firm from spreading to other firms and [possibly] threatening the collapse of the affected market."[356]

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[351] 11 U.S.C. § 362(a).

[352] *Id.* §§ 365, 547, 548.

[353] *Id.* §§ 362(b)(27), 546(e)–(g), (j), 555, 556, 559, 560, 561, 562. Each of these terms is defined in section 101 or 741 of theBankruptcy Code. *Id.* §§ 101, 741. Steven L. Schwarcz, *Derivatives and Collateral: Balancing Remedies and Systemic Risk*, 2015 Ill. L. Rev. , at *1–2 (forthcoming 2015) ("Bankruptcy law in the United States provides unique protections to creditors in derivatives transactions. Unlike other creditors of a debtor, derivatives counterparties have special rights and immunities in the bankruptcy process, including virtually unlimited enforcement rights against the debtor (the 'safe harbor'). The safe harbor's articulated justification is that it is necessary to protect against systemic risk — the risk that an event will trigger a loss of economic value or confidence in a substantial segment of the financial system that is serious enough to have significant adverse effects on the real economy."), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2419460.

[354] S. Rep. No. 95-989, at 8 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787.

[355] The legislative history provides, in relevant part:

> The resulting discrimination in treatment [between commodities and securities] appears to have been inadvertent. It plainly is not supportable on policy grounds. It is further the Commission's view that the amendments now under consideration present an effective solution to these problems by assuring equality of treatment as between the securities and commodities industries.

Bankruptcy of Commodity and Securities Brokers: Hearings before the Subcomm. on Monopolies and Commercial Law of the H. Comm. on the Judiciary, 97th Cong. 239 (1981) (testimony of Bevis Longstreth, Comm'r, Sec. & Exch. Comm'n).

[356] H.R. Rep. No. 97-420, at 1 (1982), *reprinted in* 1982 U.S.C.C.A.N. 583, 583. For a review of the justifications for and impact of the bankruptcy safe harbors, *see* Schwarcz, *Derivatives and Collateral*, *supra* note 353, at *4–5 ("The purpose of the safe harbor is to help ensure that large derivatives dealers can enforce their remedies against a failed counterparty, thereby minimizing the dealer's losses and reducing its chances of collapse. There are however, at least three possible flaws in that logic. The first flaw is that if a dealer itself is a defaulting counterparty, the safe harbor enables the dealer's other counterparties to enforce their remedies, thereby hastening the dealer's collapse. This occurred, for example, in the case of [Lehman Brothers]. The second flaw is that there is 'little actual evidence to support' the claim that the collapse of a dealer might systemically disrupt the derivatives market. . . . [Lastly], the safe harbor itself appears to incentivize market concentration by enabling dealers and other parties to virtually ignore counterparty risk. . . . For this reason, creditors 'are not overly concerned with their debtor's financial stability, because they protect themselves with the debtor's collateral, rather than with their understanding of the firm itself.'").

Congress further expanded the safe harbors in 1982, 1990, 1994, 2005, and 2006.[357] Some commentators argue that these amendments expanded the safe harbors well beyond their original purpose and now impede a debtor's reorganization efforts to the detriment of other stakeholders.[358] The Commission considered the important role that the safe harbors play in financial markets and carefully balanced the competing concerns throughout its deliberations. As described below, the Commission recommended certain targeted amendments to the safe harbors that continue protections for qualified financial contracts in appropriate circumstances, but reduce opportunities for manipulation or abuse.

1. Scope of Section 546(e) Safe Harbors

Recommended Principles:

- Section 546(e) of the Bankruptcy Code should be amended to remove protection from avoidance actions for beneficial owners of privately issued securities in connection with pre-petition transactions using some or all of the debtor's assets to facilitate the transaction (e.g., leveraged buyouts).
- Section 546(e) should continue the existing protection from avoidance actions for (i) securities industries participants who act as conduits in both public and private securities transactions and (ii) public securities holders.
- Section 546(e) and the parallel provisions of section 546 applicable to other qualified financial contracts should continue to exclude from the safe harbors transfers made with actual intent to hinder, delay, or defraud, and such transfers should remain voidable under section 548(a)(1)(A).
- The exclusion from the safe harbors for transfers made with actual intent to hinder, delay, or defraud should also apply to transfers made with similar intent that are voidable under applicable state fraudulent transfer or conveyance laws avoidable by the trustee under section 544(b).
    - o For purposes of this principle, a publicly issued security should include a security of a debtor or its affiliate that is registered under section 12 of the Securities Exchange Act of 1934 (15 U.S.C. § 78l) or sold in reliance on Rule 144A or Regulation S under the Securities Act of 1933 (15 U.S.C. § 77a et seq.).

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[357] For a review of the history of the safe harbors, *see* Charles W. Mooney, *The Bankruptcy Code's Safe Harbors for Settlement Payments and Securities Contracts: When is Safe Too Safe?*, 49 Tex. Int'l L.J. 243, 245–50 (2014); Stephen J. Lubben, *Systemic Risk & Chapter 11*, 82 Temp. L. Rev. 433 (2009); Edward R. Morrison & Joerg Riegel, *Financial Contracts and the New Bankruptcy Code: Insulating Markets from Bankrupt Debtors and Bankruptcy Judges*, 13 Am. Bankr. Inst. L. Rev. 641 (2006). *See generally* Eleanor Heard Gilbrane, *Testing the Bankruptcy Code Safe Harbors in the Current Financial Crisis*, 18 Am. Bankr. Inst. L. Rev. 241 (2010) (discussing legislative history of safe harbor provisions and amendments thereto).

[358] *See, e.g.*, Stephen J. Lubben, *Repeal the Safe Harbors*, 18 Am. Bankr. Inst. L. Rev. 319 (2010); Frank Partnoy & David A. Skeel, Jr., *The Promise and Perils of Credit Derivatives*, 75 U. Cin. L. Rev. 1019 (2007); Franklin R. Edwards & Edward R. Morrison, *Derivatives and the Bankruptcy Code: Why the Special Treatment?*, 22 Yale J. on Reg. 91 (2005).

a. Scope of Section 546(e) Safe Harbors: Background

Section 546(e) of the Bankruptcy Code protects certain types of transactions from avoidance by the trustee[359] under sections 544, 545, 547, 548(a)(1)(B) and 548(b). (These sections generally allow the trustee to avoid, among other things, pre-petition fraudulent or preferential transfers, as well as unperfected securities interests, and to recover the value of those transfers for the benefit of the estate.) Specifically, a trustee may not avoid a margin payment or settlement payment made by, to, or for the benefit of a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency. In addition, similar protection applies to transfers made by, to, or for the benefit of any of these parties in connection with a securities contract.

A "settlement payment" is defined in section 741(8) of the Bankruptcy Code as a "preliminary settlement payment, a partial settlement payment, an interim settlement payment, a settlement payment on account, a final settlement payment, or any other similar payment commonly used in the securities trade."[360] Courts have interpreted the term to include many kinds of transactions arguably not within the original legislative intent to insulate the securities transfer system from fraudulent conveyance and preference action. For example, courts have protected transfers to the beneficial holders of privately issued securities in leveraged buyouts that arguably have no impact on the securities transfer system.[361] Some commentators also question whether the provision should protect the beneficial owners of publicly held securities or, rather, should be limited solely to securities industries participants who act as conduits in both public and private securities transactions.[362]

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[359] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[360] 11 U.S.C. § 741.

[361] Courts originally limited application of section 546(e) in the fraudulent transfer context to conduits and the beneficial owners of publicly held securities; they did not protect the beneficial owners of privately issued securities. *See, e.g.*, Jewel Recovery, L.P. v. Gordon, 196 B.R. 348, 353 (N.D. Tex. 1996); Kapila v. Espirito Santo Bank (*In re* Bankest Capital Corp.), 374 B.R. 333, 346 (Bankr. S.D. Fla. 2007); Official Comm. of Unsecured Creditors v. Lattman (*In re* Norstan Apparel Shops, Inc.), 367 B.R. 68, 77 (Bankr. E.D.N.Y. 2007). Nevertheless, the Third, Sixth, and Eighth Circuit Courts have held that beneficial owners of both publicly and privately held securities are protected. *See, e.g.*, Contemporary Indus. Corp. v. Frost, 564 F.3d 981 (8th Cir. 2009); QSI Holdings, Inc. v. Alford (*In re* QSI Holdings, Inc.), 571 F.3d 545 (6th Cir. 2009), *cert. denied*, 558 U.S. 1148 (2010); Brandt v. B.A. Capital Co. (*In re* Plassein Int'l Corp.), 590 F.3d 252 (3d Cir. 2009), *cert. denied*, 559 U.S. 1093 (2010).

[362] For a discussion of related approaches to limiting the scope of section 546(e), see, *e.g.*, Samir D. Parikh, *Saving Fraudulent Transfer Law*, 86 Am. Bankr. L.J. 305, 344 n. 225 (2012) ("Another basis for narrowing the scope of section 546(e) has been termed the 'mere conduit' argument. The argument was introduced by the Eleventh Circuit Court of Appeals in *Munford v. Valuation Research Corp. (In re Munford, Inc.)*, 98 F.3d 604 (11th Cir. 1996), *cert. denied*, 522 U.S. 1068 (1998). In *Munford*, the settlement payments at issue were made to a recognized financial institution. But the court held that the financial institution 'was nothing more than an intermediary or conduit' because it did not acquire a beneficial interest in the funds. The court reasoned that since the financial institution 'never acquired a beneficial interest in either the funds or the shares,' it was not a 'transferee' as that term is used in the Bankruptcy Code, and section 546(e) was inapplicable. The argument has been roundly criticized, and it is unclear if any other court has relied on this rationale in narrowing section 546(e)'s exemption. The deficiency in the 'mere conduit' argument is that section 546(e) in no way requires that the financial institution to which or from which payments were made or received acquire a 'beneficial interest' in the funds. Financial institutions

b. Scope of Section 546(e) Safe Harbors: Recommendations and Findings

As written and applied, the section 546(e) safe harbor has insulated settlement payments to the ultimate beneficiaries of leveraged buyouts ("LBOs") and similar transactions, even if the securities were privately issued. Absent the safe harbors, these payments would be potentially voidable as fraudulent transfers. This outcome appears anomalous in light of the policy underlying section 546(e): to insulate the securities transfer system from fraudulent conveyance and preference actions.

The Commission reviewed the development of section 546(e) under both the Bankruptcy Code and the case law. They noted the uncertainty in the courts' interpretations of the term "settlement payment" and suggested that similar issues may arise with respect to the term "transfers . . . in connection with a securities contract," which was added by the BAPCPA Amendments. The Commissioners discussed how to balance the expectations of the financial markets with the need to protect the debtor's estate and other stakeholders from pre-petition transfers that (i) do not affect secondary markets and (ii) constitute preferences or fraudulent transfers under bankruptcy law or applicable state law.

The Commissioners evaluated the different types of transactions that may be protected by the section 546(e) safe harbor and noted the particular imbalance in LBOs involving privately issued securities. As explained by the Honorable Christopher S. Sontchi of the U.S. Bankruptcy Court for the District of Delaware during his testimony before the House Judiciary Committee's Subcommittee on Regulatory Reform, Commercial and Antitrust Law:

> As written and applied, however, the section 546(e) safe harbor has insulated from preference and fraudulent conveyance actions the ultimate beneficial recipients of a settlement payments, including insiders in private transactions. The result has been to provide officers and directors of bankrupt companies with an almost "too good to be true" defense to preference and fraudulent conveyance actions.[363]

In these instances, the Commissioners found it difficult to reconcile the protections that courts were affording the beneficial owners of privately issued securities with the original purpose of the legislation. The Commissioners were most troubled by situations involving pre-petition transfers in connection with an LBO that leaves the debtor with insufficient capital and that is attributable, at least in part, to bad faith on the part of the debtor's insiders. Absent the section 546(e) safe harbor that has been extended to LBO transactions, the debtor in possession could challenge such a pre-

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involved in securities transactions rarely acquire a beneficial interest in the funds that they handle. The 'mere conduit' argument is an outlier in the debate regarding section 546(e)." *Id.* at 609–10 (citations omitted).

[363] *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives, Hearing Before the H. Subcomm. on Regulatory Reform, Commercial and Antitrust Law*, 113th Cong. 12 (2014) (statement of the Honorable Christopher S. Sontchi, U.S. Bankruptcy Judge for the District of Delaware).

petition transfer as a fraudulent transfer[364] and possibly avoid it for the benefit of the estate and other stakeholders harmed by the depletion in the debtor's value. Nevertheless, section 546(e) prevents the debtor in possession from bringing fraudulent transfer claims, even against insiders of the debtor, unless the transfer was made within two years before bankruptcy and with actual intent to hinder, delay, or defraud creditors.

In balancing the competing considerations in the LBO context, the Commissioners discussed the need to continue to protect securities industries participants that act as conduits in pre-petition transfers. The Commissioners noted that the beneficial owner of the privately issued securities should be deemed the initial transferee for purposes of fraudulent transfer law, and that conduits should not be affected by any limited change to section 546(e) in this respect. The Commission agreed, however, that conduits should be expressly covered by section 546(e) to avoid any uncertainty that might implicate the financial markets.

The Commission likewise considered the merits of limiting section 546(e) solely to securities industries participants that act as conduits, but ultimately it determined that allowing fraudulent transfer claims against the beneficial owners of publicly issued securities would have the potential to affect the securities transfer system — a considerable difference from privately issued securities transfers. The Commissioners explored whether they could strike a reasonable compromise by limiting the protections of the section 546(e) safe harbor to beneficial holders of publicly issued securities that received the transfers in good faith. The Commission generally agreed that the good faith standard could align with the objectives of both the safe harbor and fraudulent transfer law, but it acknowledged the difficulty in administering and litigating such a standard. Some of the Commissioners strongly believed that application of the good faith standard and the attendant challenges posed by distinguishing good faith transactions from bad faith transactions could create substantial uncertainty in the markets. Accordingly, the Commission voted to maintain the safe harbor protections for publicly issued securities, without any good faith qualification.

Another issue that arises with respect to the section 546(e) safe harbor is whether its protections are limited to fraudulent transfer actions under section 548 of the Bankruptcy Code or whether they also extend to such actions under state law that are avoidable by the trustee under section 544(b) of the Bankruptcy Code or avoidable by a litigation trust or individual creditors after confirmation of a chapter 11 plan. The courts are split on this issue. Even though the statute purports to limit the trustee's ability to bring avoidance actions, some courts have extended the protection to preclude state law causes of actions.[365] Other courts have held that "there is no statutory text making section 546(e) applicable to claims brought on behalf of individual creditors, or displacing their state law rights, by plain meaning analysis or otherwise."[366] The Commission evaluated each of these positions and discussed the practical consequences

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[364] A fraudulent transfer generally involves a transfer of a company's assets for less than reasonably equivalent value at a time that the debtor is insolvent or is rendered insolvent by the transfer (a "constructively fraudulent transfer").

[365] *See* Whyte v. Barclays Bank PLC, 494 B.R. 196 (S.D.N.Y. 2013).

[366] Weisfelner v. Fund 1 (*In re* Lyondell Chem. Co.), 503 B.R. 348 (Bankr. S.D.N.Y. 2014). *See also In re* Tribune Co. Fraudulent Conveyance Litig., 499 B.R. 310 (S.D.N.Y. 2013).

of allowing state law actions to proceed while precluding federal causes of action brought by the trustee on behalf of the estate. Ultimately, the Commission concluded that the exclusion from the safe harbors for transfers made with actual intent to hinder, delay, or defraud should apply whether the action is brought under federal or state law. Thus, the trustee will be able to avoid an actual intent fraudulent transfer whether brought under section 544(b) or 548. The Commission was not able to reach a consensus on extending the protections of the section 546(e) safe harbor to actions outside a federal bankruptcy case.

Notably, the Commission's recommended principles on section 546(e) concentrate largely on pre-petition transactions in which some or all of the debtor's assets are being used to facilitate the transaction (e.g., LBOs). Except as otherwise specifically discussed in this Report, the Commission does not recommend reducing the coverage of section 546(e) for securities purchases and sales, securities options, securities loans, margin loans, and other transfers and transactions that are currently protected by section 546(e).

2. Treatment of Repurchase Agreements Under Safe Harbors

Recommended Principles:

- The safe harbor for repurchase agreements should be narrowed as a means to foster financial stability, reduce interconnectedness, and exclude disguised financing arrangements.
  - o As a preferred option, the safe harbors for repurchase agreements should be limited to the kinds of agreements included in the pre-BAPCPA definitions of "repurchase agreement" in section 101(47) and "securities contract" in section 741(7) of the Bankruptcy Code.
  - o Alternatively, at a minimum, the safe harbors for repurchase agreements should be amended to exclude repurchase agreements that are, in essence, committed financing arrangements for mortgage loan portfolios. Specifically, the definitions of "repurchase agreement" in section 101(47) and "securities contract" in section 741(7) should be amended to exclude repurchase agreement facilities that have the economic attributes of traditional mortgage warehouse facilities, which typically are more akin to committed secured financing arrangements than true repurchase agreements.

a. Treatment of Repurchase Agreements Under Safe Harbors: Background

Sections 555 and 559 of the Bankruptcy Code allow certain parties, including financial institutions and financial participants, to liquidate, terminate, or accelerate a securities contract or repurchase agreement without relief from the automatic stay of section 362 or concern for the prohibition on enforcement of ipso facto clauses in section 365(e) of the Bankruptcy Code.[367] In addition, the automatic stay generally does not apply to setoffs and the exercise of other remedies by the nondebtor party under a

[367] 11 U.S.C. §§ 555, 559.

repurchase agreement.[368] Section 559 was added to the Bankruptcy Code in 1984 to treat repurchase agreements the same as commodities and securities contracts under the safe harbors, in large part to protect the financing of the national debt.[369]

In 2005, pursuant to the BAPCPA Amendments, Congress amended the scope of sections 555 and 559 by expanding the definitions of "securities contracts" and "repurchase agreements" and adding "financial participants" to the list of protected parties under these sections.[370] Specifically, Congress added mortgage loans and any interests in mortgage loans, including repurchase transactions, to the definition of securities contracts in section 741(7) of the Bankruptcy Code.[371] Similarly, it added mortgage-related securities, mortgage loans, and interests in mortgage-related securities or mortgage loans, to the definition of repurchase agreements in section 101(47) of the Bankruptcy Code.[372] It also defined financial participant as "an entity with at least $1 billion in notional or principal amount outstanding or $100 million in mark-to-market securities contracts, commodities contracts, swap agreements, repurchase agreements, or forward contracts, with the debtor at the time of filing or on any day during the fifteen-month period preceding filing."[373]

Some commentators have questioned whether the expanded definitions of securities contracts and repurchase agreements further the underlying policies of the safe harbors.[374] For example, a committed mortgage loan repurchase agreement facility can function similarly to a conventional secured mortgage warehouse facility, but arguably qualify for protections under the safe harbors. In a typical mortgage warehouse transaction, the loan originator obtains short-term financing from a lender through a credit facility or similar arrangement secured by a pledge of mortgages or other assets owned by the originator (often to provide short-term financing until the mortgages can be deposited into a securitization pool). The originator can transfer or sell the mortgages or assets and would typically use any proceeds to pay down the facility with

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[368] *Id.* § 362(b)(7).

[369] *See* 5 Collier on Bankruptcy ¶ 559.LH ("The effective functioning of the repo market can only be assured if repo investors will be protected against open-ended market loss arising from the insolvency of a dealer or other counterparty in the repo market. The repo market is as complex as it is crucial. It is built upon transactions that are highly interrelated. A collapse of one institution involved in repo transactions could start a chain reaction, putting at risk hundreds of billions of dollars and threatening the solvency of many additional institutions. Since the repo market is important to the health of the country's financial system, it is desirable that the Code be interpreted and implemented in a manner which protects that market without creating an unfair result for debtors. . . . The proposed amendments will take an important first step toward meeting the full objective of Public Law 97-222 by expressly providing that similar protections apply to the crucial portions of the repo market involving U.S. Government and agency obligations, certificates of deposit, and eligible bankers' acceptances. The structure of the proposed amendments is based upon the addition to the Code of new definitions of 'repo participant' and 'repurchase agreement' and the making of conforming changes in relevant provisions of the Code. The proposed amendments are intended to afford participants in the repo market the same treatment with respect to the stay and avoidance provisions of the Code that Public Law 97-222 explicitly provided stockbrokers, securities clearing agencies, commodity brokers and forward contract merchants in connection with securities contracts, commodity contracts and forward contracts.") (citations omitted).

[370] *See id.*

[371] 11 U.S.C. § 741(7).

[372] *Id* § 101(47).

[373] *Id* § 101(22A). *See also* Mooney, *supra* note 357, at 249.

[374] *See, e.g.*, Calyon N.Y. Branch v. Am. Home Mortg. Corp. (*In re* Am. Home Mortg., Inc.), 379 B.R. 503 (Bankr. D. Del. 2008). *See also* Mooney, *supra* note 357, at 251–52.

the lender.[375] Such secured transactions do not, however, present the same contagion or market risks posed by true repurchase agreements and arguably fall outside the scope of the safe harbors.

Moreover, commentators robustly debate the ongoing utility of safe harbors for repurchase agreements covering mortgage loans and nonagency mortgage-backed securities. Some commentators argue that mortgage loan repurchase agreements should no longer be protected by the safe harbors.[376] These commentators have called for excluding mortgage interests and mortgage-related transactions from the definitions of repurchase agreements and securities agreements. They assert, among other things, that mortgages are illiquid assets and therefore fall outside the justification for safe harbor protection (i.e., "preservation of the liquidity of investments").[377] Others support maintaining broad protection for repurchase agreements, including mortgage repurchase agreements, based on the interconnectedness of the markets and the increasing importance of repurchase agreements in both domestic and global investment portfolios.[378] With respect to repurchase agreements specifically, these supporters believe that the protections afforded to such contracts by the safe harbors reduce the cost of credit and support domestic real estate markets.[379] These supporters also suggest that any restrictions on investment in mortgage loans by financial institutions are best implemented through carefully considered prudential regulation rather than through the "blunt instrument" of a change to the Bankruptcy Code's safe harbors. Both sides rely on anecdotal evidence to support their respective positions.

b. Treatment of Repurchase Agreements Under Safe Harbors: Recommendations and Findings

Repurchase agreements as financial instruments provide liquidity and flexibility to market participants. They also represent a large component of the financial markets.[380]

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[375] These secured transactions are to be contrasted with repurchase agreements, which typically involve two agreements: first, the originator sells its mortgages or other assets to the lender in exchange for funds; second, the originator agrees to repurchase the mortgages or other assets for the original price plus a premium at a date certain (usually one year after the original sale).

[376] *See, e.g.*, Edward R. Morrison et al., *Rolling Bank the Repo Safe Harbors*, 69 Bus. Law. 1015, 1019 (2014) (proposing to "scal[e] back the repo safe harbor to approximately the 1984 scope for 'repurchase agreements', namely, safe harboring only repos on U.S. Treasury and Agency securities backed by the government's full faith and credit, certificates of deposits, and bankers acceptances").

[377] *Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives, Hearing Before the H. Subcomm. on Regulatory Reform, Commercial and Antitrust Law*, 113th Cong. 9 (2014) (statement of the Honorable Christopher S. Sontchi, U.S. Bankruptcy Judge for the District of Delaware). Judge Sontchi also explained: "The current safe harbors for repurchase agreements allow for 'runs' on financial institutions such as American Home Mortgage by counterparties/lenders which are not subject to the automatic stay and, thus, are free to terminate repos and other financial contracts en masse." *Id.* at 10.

[378] *See* Steven L. Schwarcz & Ori Sharon, *The Bankruptcy-Law Safe Harbor for Derivatives: A Path-Dependence Analysis*, 71 Wash. & Lee L. Rev. 1715 (2014).

[379] *See, e.g., Exploring Chapter 11 Reform: Corporate and Financial Institution Insolvencies; Treatment of Derivatives, Hearing Before the H. Subcomm. on Regulatory Reform, Commercial and Antitrust Law*, 113th Cong. 35 (2014) (statement of Seth Grosshandler, Partner at Cleary, Gottlieb, Steen & Hamilton LLP) ("In particular, the safe harbor for repurchase agreements on residential mortgage-backed securities and whole loan mortgages serves to reduce the cost of mortgage financing to homeowners.").

[380] Data as of June 2014 suggest that the value of outstanding repurchase agreements in the United States is approximately $4 trillion. *See* Elizabeth Holmquist & Josh Gallin, *Repurchase Agreements in Financial Accounts*

The Commissioners recognized the important role that repurchase agreements play in the markets, particularly those initiated on an overnight or short-term basis. Some of the Commissioners agreed with those commentators who distinguish mortgage loan repurchase agreements from other kinds of repurchase agreements structured around more liquid assets such as U.S. government and agency securities. The ability to liquidate the transferred assets immediately upon a default is a central and important feature of traditional repurchase agreements.

The Commissioners discussed the advantages and disadvantages of providing safe harbor protections to mortgage loan repurchase agreements and recognized the challenges to reducing these protections. Some of the Commissioners believed that the risks posed by removing mortgage loan repurchase agreements from the safe harbors were significantly outweighed by the potential benefits. These Commissioners were persuaded by the arguments that inclusion of these repurchase agreements encouraged runs on debtor originators and accelerated (rather than reduced) contagion.[381] The Commission voted to scale back the safe harbors for repurchase agreements to the pre-BAPCPA definitions of repurchase agreement and securities contract.[382]

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of the United States, June 30, 2014, *available at* http://www.federalreserve.gov/econresdata/notes/feds-notes/2014/repurchase-agreements-in-the-financial accounts-of-the-united-states-20140630.html.

[381] *See* Morrison, et al., *Rolling Back the Repo Safe Harbors*, *supra* note 376, at 1017 (discussing safe harbors for repurchase agreements and observing that "there is little evidence that they serve this purpose"). "Instead, considerable evidence shows that, when they matter most — in a financial crisis — the safe harbors exacerbate the crisis, weaken critical financial institutions, destabilize financial markets, and then prove costly to the real economy." *Id.* For a general discussion of these issues, see Schwarcz, *Derivatives and Collateral*, *supra* note 353, at *4–5 ("The purpose of the safe harbor is to help ensure that large derivatives dealers can enforce their remedies against a failed counterparty, thereby minimizing the dealer's losses and reducing its chances of collapse. There are however, at least three possible flaws in that logic. The first flaw is that if a dealer itself is a defaulting counterparty, the safe harbor enables the dealer's other counterparties to enforce their remedies, thereby hastening the dealer's collapse. This occurred, for example, in the case of [Lehman Brothers]. The second flaw is that there is 'little actual evidence to support' the claim that the collapse of a dealer might systemically disrupt the derivatives market. . . . [Lastly], the safe harbor itself appears to incentivize market concentration by enabling dealers and other parties to virtually ignore counterparty risk. . . . For this reason, creditors 'are not overly concerned with their debtor's financial stability, because they protect themselves with the debtor's collateral, rather than with their understanding of the firm itself.' ").

[382] Between 1994 and 2006, the Bankruptcy Code had defined "***securities contract***" as follows:

> "securities contract" means contract for the purchase, sale, or loan of a security, including an option for the purchase or sale of a security, certificate of deposit, or group or index of securities (including any interest therein or based on the value thereof), or any option entered into on a national securities exchange relating to foreign currencies, or the guarantee of any settlement of cash or securities by or to a securities clearing agency; . . . .

11 U.S.C. § 741(7) (effective Oct. 22, 1994 to Dec. 11, 2006). Between 2000 and 2004, the Bankruptcy Code had defined "***repurchase agreement***" as follows:

> "repurchase agreement" (which definition also applies to a reverse repurchase agreement) means an agreement, including related terms, which provides for the transfer of certificates of deposit, eligible bankers' acceptances, or securities that are direct obligations of, or that are fully guaranteed as to principal and interest by, the United States or any agency of the United States against the transfer of funds by the transferee of such certificates of deposit, eligible bankers' acceptances, or securities with a simultaneous agreement by such transferee to transfer to the transferor thereof certificates of deposit, eligible bankers' acceptances, or securities as described above, at a date certain not later than one year after such transfers or on demand, against the transfer of funds; . . . .

11 U.S.C. § 101 (effective Dec. 21, 2000 to Oct. 24, 2004).

Other Commissioners observed that markets are increasingly global and interconnected, and they found value in maintaining the same level of protection for all true repurchase agreements. Some of these Commissioners, however, also agreed that the safe harbors should not protect disguised mortgage warehouse arrangements. The Commissioners explored removing transactions that facilitate short-term financing through a pledge of the assets, rather than a true sale. In the course of these discussions, the Commissioners discussed specifically excluding committed mortgage loan repurchase agreement facilities that function as mortgage warehouse facilities from the definitions of repurchase agreements and securities contracts and the safe harbors under the Bankruptcy Code. The Commission voted in favor of this exclusion, subject to its preference for a more extensive reduction in the safe harbors for repurchase agreements, as described in the preceding paragraph.

3. Assumption of Financial Contracts

Recommended Principles:

- Under current law, several aspects of the safe harbors make it difficult for a trustee to exercise the traditional power under section 365 of the Bankruptcy Code to assume a derivative or other financial contract. For example, counterparties' ability to enforce ipso facto clauses and terminate contracts protected by the safe harbors often make assumption of a derivative or other financial contract impossible. Moreover, the safe harbors arguably allow counterparties to remove valuable assets from the estate, such as when the debtor is in the money on the contract in question, especially if damages paid upon termination do not compensate the estate fully for loss of the contract. Nevertheless, these challenges for the trustee need to be balanced against the volatile and systemic nature of the financial markets and the need to mitigate contagion in the larger economy.
- On balance and considering the proposed revisions to the safe harbors regarding the treatment of ordinary supply contracts, repurchase agreements, and walkaway clauses under these principles, the Commission does not believe further amendments to the safe harbors with respect to a trustee's ability to assume derivative and other financial contracts are necessary or advisable. In addition, the Commission is aware of ongoing efforts to provide financially distressed systemically important financial institutions (or their subsidiaries that are parties to such contracts) with some ability to transfer derivative and other financial contracts in certain circumstances in the event that such institutions become debtors under the Bankruptcy Code. The Commission has decided to take no action with respect to such institutions.

a. Assumption of Financial Contracts: Background

One consequence of the safe harbors is that counterparties can liquidate and close out qualified financial contracts with the debtor in possession, even if the debtor in

possession's[383] positions under those contracts are in the money or the debtor in possession may be able to continue to perform or assign the contracts.[384] As explained above, counterparties to qualified financial contracts generally are not subject to the automatic stay under section 362 and the prohibition on ipso facto clauses under section 365(e). These exceptions almost always preclude a debtor in possession's ability to assume or assign qualified financial contracts because the contracts are terminated, liquidated, or accelerated on the debtor in possession's petition date or shortly thereafter.[385]

Some commentators have argued against this result and in favor of a short stay that would allow the debtor in possession some ability to assume or assign some or all of its qualified financial contracts.[386] This approach would be similar to that provided for systemically important financial institutions under the Orderly Liquidation Authority ("OLA"), Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.[387] Under OLA, counterparties are enjoined for one business day from terminating, liquidating, or accelerating their positions under qualified financial contracts.[388] Likewise, under different pieces of legislation proposed in Congress to address systemically important financial institutions under federal bankruptcy law, counterparties would be subject to a 48-hour stay before they could exercise any of their rights.[389] Under OLA, the receiver is given a brief opportunity to assign the bank's qualified financial contracts (likely to a bridge or similar institution) to facilitate its resolution, provided that certain conditions are satisfied. In the case of the proposed Financial Institutions Bankruptcy Act, the debtor (a systemically important bank holding company) is given a brief opportunity to transfer the stock of its subsidiaries to a special trust under certain conditions, when the debtor's estate is the beneficial owner of such trust.[390]

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[383] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[384] *See, e.g.*, Stephen J. Lubben, *The Bankruptcy Code Without Safe Harbors*, 84 Am. Bankr. L.J. 123, 129 (2010).

[385] For a critique of the Bankruptcy Code's treatment of qualified financial contracts in this respect, *see* Stephen Lubben, *Derivatives and Bankruptcy: The Flawed Case for Special Treatment*, 12 Univ. Penn. J. Bus. L. 61, 65–75 (2019).

[386] *Written Statement of Professor David Skeel: NYCBC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (May 15, 2013) (suggesting a three-day stay), *available at* Commission website, *supra* note 55; *Written Statement of Edward Murray: NYCBC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (May 15, 2013) (stating that a short stay may be useful and that both the FDIC regime for U.S. banks and the Dodd-Frank Orderly Liquidation Regime both allow a short stay), *available at* Commission website, *supra* note 55.

[387] 12 U.S.C. § 5390(c)(10)(B).

[388] *Id.*

[389] *See* Taxpayer Protection and Responsible Resolution Act of 2014, S.1861, 113th Cong. § 1407 (2014) (adopting a proposal commonly referred to as "chapter 14"); Financial Institution Bankruptcy Act of 2014, H. 5421, 113th Cong. § 1187 (2014) (adopting a proposal commonly referred to as "subchapter V").

[390] OLA is discussed further in Section IX.D, *SIFIs and Single Point of Entry Schemes*.

b. Assumption of Financial Contracts: Recommendations and Findings

The Commission considered the potential utility of incorporating a short stay imposed on counterparties before they would be able to exercise their rights under qualified financial contracts against a debtor in possession upon the filing of its chapter 11 case. The Commissioners noted that this kind of short-term stay would primarily benefit the debtor in possession by allowing it to potentially (i) assume certain contracts when the debtor in possession is in the money or could continue to perform or (ii) assign such contracts to another entity. Although in theory both options are appealing and hold potential value for the estate, the Commissioners questioned the ability of a debtor in possession to review its qualified financial contracts in such a meaningful and expeditious manner early in the chapter 11 case. They also raised concerns about structuring and funding a transaction early in the case in which the debtor in possession could effectively assign and transfer its qualified financial contracts. Many of the Commissioners also believed that, given the market stability and the systemic issues relating to these contracts, the debtor in possession would need to provide some type of adequate assurance to counterparties during the short-term stay, or otherwise compensate counterparties for any loss in value that they suffered while they were enjoined from exercising their rights under the contracts.

Given these challenges, the Commissioners reexamined the concerns commonly expressed by parties in the safe harbor context in connection with the termination, liquidation, or acceleration of qualified financial contracts. These concerns often involve an estate losing the value of the debtor in possession's position under a contract that is in the money or involve perceived abuses or unwarranted expansion of the safe harbor protections to transactions not directly related to the securities transfer system. The Commission agreed that its recommended principles addressing ordinary supply contracts, repurchase agreements, and walkaway clauses adequately addressed its primary concerns about the safe harbors. On balance, imposing a stay of the safe harbor protections would not enhance the debtor's rehabilitation efforts. The Commission also acknowledged that the balancing of these issues may be different for systemically important financial institutions, but it noted pending legislative proposals on this topic.

4. Section 562 and "Commercially Reasonable Determinants of Value"

Recommended Principles:

- Section 562(b) should define "commercially reasonable determinants of value" as determinants of value specified in the contract that are not manifestly unreasonable or, in the absence of such determinants of value, commercially reasonable market prices.

a. Section 562 and "Commercially Reasonable Determinants of Value": Background

Section 562 of the Bankruptcy Code addresses the "timing of damage measurement" when a qualified financial contract is rejected by a trustee[391] or liquidated, terminated, or accelerated by a nondebtor counterparty.[392] As a general rule, section 562(a) provides that damages should be measured as of the earlier of the date when the trustee rejects the qualified financial contract or the date when the nondebtor counterparty liquidates, terminates, or accelerates the qualified financial contract. If no commercially reasonable determinants of value exist on that date, however, section 562(b) provides that damages should be measured as soon as commercially reasonable determinants of value are available.[393] Accordingly, the meaning of the term "commercially reasonable determinants of value" may play a central role in measuring damages under qualified financial contracts.

Two issues commonly arise under section 562(b) and the application of the commercially reasonable determinants of value standard. First, there may be many commercially reasonable determinants of value, and what is "commercially reasonable" may depend on the surrounding circumstances. The court in *American Home Mortgage Holdings, Inc.* addressed this precise issue: the debtor suggested that the assets could be valued using a discounted cash flow analysis on one date (showing assets were worth more than the repurchase price) and the counterparty argued that the assets could not be valued until a later date when an actual price was available for the assets (showing assets were worth less than the repurchase price).[394] The district and appellate courts in *American Home* agreed with the debtor's analysis. The Commissioners questioned this result and noted that "commercially reasonable" is used in Article 9 of the Uniform Commercial Code in the context of sales procedures that are customary for the relevant market.

Second, section 562 does not address the methodology to be used in calculating damages. Specifically, it is uncertain whether parties must adhere to a valuation methodology established by their contract or if they may use an alternative methodology provided that it is commercially reasonable under the circumstances. The importance of this decision becomes more acute if commercially reasonable

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[391] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[392] 11 U.S.C. § 562.

[393] The legislative history of section 562 provides:

> The party determining damages is given limited discretion to determine the dates as of which damages are to be measured. Its actions are circumscribed unless there are no "commercially reasonable" determinants of value for it to measure damages on the date or dates of either rejection or liquidation, termination or acceleration. The references to "commercially reasonable" are intended to reflect existing state law standards relating to a creditor's actions in determining damages.

H.R. Rep. 109-31(I), H.R. Rep. No. 31(I) (2005), *reprinted in* 2005 U.S.C.C.A.N. 88.

[394] *In re* Am. Home Mortg. Holdings, Inc., 411 B.R. 181 (Bankr. D. Del. 2009), *aff 'd*, 637 F.3d 246 (3d Cir. 2011).

determinants of value for purposes of the methodology required by the contract do not exist on a particular date, but the assets could be valued as of that date under another commercially reasonable methodology.

b. Section 562 and "Commercially Reasonable Determinants of Value": Recommendations and Findings

The Commission focused on two goals relating to section 562 of the Bankruptcy Code: providing certainty and preserving the expectations of the parties to pre-petition contracts to the extent that they would not directly conflict with bankruptcy law or policy. The Commissioners reflected on the issues presented by the *American Home Mortgage* case and whether courts would potentially benefit from a determination about which type of valuation methodology should be used to calculate damages. Given the relevant policies of promoting market stability and respecting pre-petition bargains whenever possible, the Commission determined that the contract terms should govern damages calculations in the first instance, unless those terms are manifestly unreasonable. The Commission used the "manifestly unreasonable" standard because precedent for that term in this context exists under section 9-603 of the Uniform Commercial Code.

In addition, the Commission found value in specifying an appropriate methodology in the event that the contract is silent about damages calculation, or the contract provides a methodology that is determined to be manifestly unreasonable. The Commissioners discussed different alternatives, but ultimately agreed that the assets should be valued on the earliest date (after the triggering event) on which market prices are available. The Commissioners believed that specifying the role of the parties' contract, as well as the use of market prices when a contract fails, for purposes of "commercially reasonable determinants of value" will facilitate more efficient damages calculations under section 562.

5. Walkaway Clauses

Recommended Principles:

- The Bankruptcy Code should be amended to (i) include a definition of "walkaway clauses" substantially similar to the corresponding definitions in the Federal Deposit Insurance Act and Orderly Liquidation Authority and (ii) render unenforceable walkaway clauses in securities contracts, forward contracts, commodity contracts, repurchase agreements, swap agreements, and master netting agreements (i.e., qualified financial contracts).

a. Walkaway Clauses: Background

In general, the terms "one-way payment," "limited two-way payment," and "walkaway" refer to provisions in qualified financial contracts that, upon termination, liquidation or acceleration of a particular transaction by the nondefaulting party, based on a default by the counterparty, eliminate the benefit of the contract to the defaulting

counterparty even if the contract is in the money for that counterparty. The Bankruptcy Code does not specifically address walkaway clauses, other than in the context of repurchase agreements under section 559.[395] Yet, these provisions can significantly impact the estate's rights under qualified financial contracts if the debtor is deemed to be the defaulting party at the time of the rejection, termination, liquidation, or acceleration of the contract. For example, pursuant to a walkaway clause, a defaulting party is generally not entitled to any payments that are otherwise owed to it under the qualified financial contract (for example, if the debtor's position is in the money at the time of the triggering event). Alternatively, the defaulting party may only be permitted to use its right to any payments to offset amounts it owes to the nondefaulting party.

Notably, other laws specifically prohibit the enforcement of walkaway clauses. The Federal Deposit Insurance Act includes provisions that make walkaway clauses in qualified financial contracts of depository institutions that are in default unenforceable.[396] The Orderly Liquidation Authority, which is a resolution regime that could apply to systemically important financial institutions, also renders walkaway clauses unenforceable.[397] In addition, the Insurer Receivership Model Act, which is a model insurer insolvency act promulgated by the National Conference of Insurer Commissioners, renders walkaway clauses unenforceable in qualified financial contracts against an insurer undergoing insolvency proceedings that is deemed to be the defaulting party.[398]

b. Walkaway Clauses: Recommendations and Findings

The Bankruptcy Code's silence on walkaway clauses, other than in the section 559 context, creates ambiguity around their enforcement. The Commissioners discussed the cost of this uncertainty, both in terms of *ex ante* bargaining and *ex post* litigation. Courts are required to interpret walkaway clauses in qualified financial contracts in chapter 11 cases with little guidance and, presumably, in reliance on state law.[399] This approach could produce results that are not only inconsistent with other chapter 11 cases, but also conflict with other federal and state laws. Accordingly, the Commission voted to preclude the enforcement of walkaway clauses in qualified financial contracts in chapter 11 cases.

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[395] Section 559 of the Bankruptcy Code provides that, when a repo participant or financial participant liquidates one or more repurchase agreements with the debtor under which the repo participant or the financial participant agreed to deliver assets to the debtor, the repo participant or financial participant must pay to the debtor any excess value over the repurchase price that such liquidation yields, less any expenses in connection with the liquidation sale. *See* 11 U.S.C. § 559. Section 559 applies regardless of whether or not a repurchase agreement provides the debtor with payment rights.

[396] 12 U.S.C. § 1821(e)(8)(G)(i).

[397] *Id.* § 5390(c)(8)(F)(i). OLA and systemically important financial institutions are discussed in greater detail in Section IX.D, *SIFIs and Single Point of Entry Schemes*.

[398] Model Insurer Receivership Act § 711.

[399] *See* Drexel Burnham Lambert Prod. Corp. v. Midland Bank PLC, 1992 U.S. Dist. LEXIS 21223 (S.D.N.Y. Nov. 10, 1992) (applying New York law to render walkaway clause unenforceable).

6. Exclusion of "Ordinary Supply Contracts" from Safe Harbors

Recommended Principles:

- The Bankruptcy Code should be amended to prevent nondealer counterparties to physical supply contracts from benefiting from the safe harbor protections.

a. Exclusion of "Ordinary Supply Contracts" from Safe Harbors: Background

As noted above, the safe harbors provide significant protections for counterparties to qualified financial contracts that otherwise are not available to creditors and contract parties under the Bankruptcy Code. These protections provide exceptions to several generally applicable bankruptcy rules and are focused on protecting the securities transfer system and the commodity hedging system and promoting market stability. Accordingly, the contracts included within the scope of "qualified financial contracts" are important from the perspectives of both the estate and counterparties.

Generally speaking, qualified financial contracts include commodity contracts, forward contracts, securities contracts, repurchase agreements, and swap agreements, as well as related master netting agreements, as those terms are defined in the Bankruptcy Code. These definitions are worded fairly broadly. For example:

- The term "forward contract" is defined as including "a contract (other than a commodity contract, as defined in section 761) for the purchase, sale, or transfer of a commodity, as defined in section 761(8) of this title, or any similar good, article, service, right, or interest which is presently or in the future becomes the subject of dealing in the forward contract trade, or product or byproduct thereof, with a maturity date more than two days after the date the contract is entered into, including, but not limited to, a repurchase or reverse repurchase transaction (whether or not such repurchase or reverse repurchase transaction is a 'repurchase agreement', as defined in this section) consignment, lease, swap, hedge transaction, deposit, loan, option, allocated transaction, unallocated transaction, or any other similar agreement."[400]
- The term "commodities contract" means, among other things, "with respect to a futures commission merchant, contract for the purchase or sale of a commodity for future delivery on, or subject to the rules of, a contract market or board of trade."[401]
- The term "swap contract" includes, "a commodity index or a commodity swap, option, future, or forward agreement."[402]

Consequently, parties have argued and some courts have held that ordinary supply agreements constitute protected qualified financial contracts under the Bankruptcy Code

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[400] 11 U.S.C. § 101(25).
[401] *Id.* § 761(4).
[402] *Id.* § 101(53B).

safe harbors.[403] As the Fifth Circuit explained, courts must "apply the statutory provisions as Congress wrote them," and it found no grounds for excluding the electricity requirements contract from the Bankruptcy Code's definition of forward contracts.[404]

Although many long-term supply contracts have some hedging component to them, some courts and commentators have questioned whether the objectives of the safe harbors are best served by including ordinary supply agreements within those protections. As explained by the court in *National Gas Distributors*:

> Congress determined that there are legitimate reasons for creating, in the financial markets, these special exceptions to the overall protections and policies of the Code. The court understands that if contracts traded on a financial market are unraveled, the market itself could become unstable and a domino effect could occur. There is nothing to suggest that the contract between Smithfield and the debtor was traded on a financial market, so in this case only the debtor's estate and Smithfield would be affected by a recovery. There is no reason to disturb the established ability of the trustee to avoid the alleged fraudulent transfers at issue in this case.
>
> The consequences of including agreements such as the one before the court within the definition of swap agreement would be far-reaching. . . . These exceptions to the trustee's avoidance powers were intended to avoid the greater danger of market disruption and instability in the financial markets due to the domino effect likely as a result of some types of transfer avoidance. Congress certainly did not intend by the amendment to create a new, equally disruptive ripple effect within the administration of bankruptcy estates. The court must take into consideration the effect its decision will have on the overall scheme of the Bankruptcy Code. If this agreement is a swap agreement, then many of the most important aspects of the Code, including priorities of distributions to creditors and the automatic stay, will be eviscerated in even the smallest case of a farmer who contracts to sell his hogs at the end of the month for a set price. No public purpose would be served, and the result would be wholly at odds with the established aims and order of bankruptcy proceedings.[405]

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[403] *See, e.g.*, Lightfoot v. MXEnergy Elec., Inc. (*In re* MBS Mgmt. Servs., Inc.), 690 F.3d 352 (5th Cir. 2012) (characterizing electric requirements contracts as forward contracts under the Bankruptcy Code); *In re* Nat'l Gas Distribs., LLC, 556 F.3d 247 (4th Cir. 2009) (finding that natural gas supply contract could constitute a commodities forward contract and, as such, a swap agreement under the Bankruptcy Code).

[404] Lightfoot v. MXEnergy Elec., Inc. (*In re* MBS Mgmt. Servs., Inc.), 690 F.3d 352 (5th Cir. 2012).

[405] *In re* Nat'l Gas Distribs., LLC, 369 B.R. 884, 899–900 (Bankr. E.D.N.C. 2007), *rev'd on other grounds*, 556 F.3d 247 (4th Cir. 2009) (citations omitted).

b. Exclusion of "Ordinary Supply Contracts" from Safe Harbors: Recommendations and Findings

The Commissioners discussed the potential inclusion of ordinary supply contracts in the Bankruptcy Code safe harbors. The safe harbors were designed to promote liquidity and stability in financial markets. Market liquidity and stability are not furthered in a meaningful way when ordinary supply agreements are safe harbored. Although distinguishing "ordinary" supply agreements from bona fide financial contracts is difficult, the Commission found value in considering (i) whether the contract involved dealers, market makers, or other parties; and (ii) whether the contract called for the physical supply of goods used, traded, or produced by the debtor in the ordinary course of business.

The Commissioners analyzed the courts' interpretation of the terms "forward contracts" and "swap agreements" under the Bankruptcy Code. They acknowledged how an ordinary supply contract could be construed or drafted to satisfy the technical requirements of these definitions. The larger issue, however, for the Commission was whether these terms should include ordinary supply contracts.

The legislative history of the safe harbors clearly establishes a desire to protect the securities transfer system and promote market stability. Although the Commissioners could hypothesize scenarios in which subjecting the nondebtor party to an ordinary supply contract to the Bankruptcy Code's automatic stay and other provisions could possibly affect others in the market, the Commissioners found those scenarios highly unlikely and, even if possible, very limited in scope. Most ordinary supply contracts are bilateral agreements that impact only the rights of the parties bound by the contract. The Commissioners acknowledged the hardship that may be imposed on the nondebtor party by the chapter 11 filing, but they did not find such hardship significantly different from that experienced by most of the debtor's stakeholders.

In discussing the scope of qualified financial contracts, several Commissioners noted the need to critically analyze any exceptions to, or priorities created by, the Bankruptcy Code.[406] These Commissioners reiterated the importance of the policies underlying the Bankruptcy Code, including a breathing period for the debtor, a level playing field among the debtor and its stakeholders, and fair treatment of all similarly situated creditors, in facilitating a successful reorganization.[407] For example, if all or a

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[406] *See, e.g.*, Howard Delivery Service, Inc. v. Zurich Am. Ins. Co., 547 U.S. 651, 667 (2006) (noting that the Court was "guided in reaching [its] decision by the equal distribution objective underlying the Bankruptcy Code, and the corollary principle that provisions allowing preferences must be tightly construed."); Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc., 789 F.2d 98, 100 (2d Cir. 1986) ("Because the presumption in bankruptcy cases is that the debtor's limited resources will be equally distributed among his creditors, statutory priorities are narrowly construed."). *See also Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("These changes reflect a pervasive trend away from the fundamental concept of equality for similarly situated creditors in bankruptcy and, in the aggregate, make it harder for a company to reorganize. As such, MFA urges the Commission to take a fresh look at the existing categories of preferred creditors, and to strongly oppose any proposals that would create additional priority categories or other preferential treatment for particular creditor groups.").

[407] Numerous courts have held that "it is the clear policy of the Bankruptcy Code to provide the debtor with breathing space following the filing of a bankruptcy petition, continuing until the confirmation of a plan, in which to assume or reject an executory contract." *In re* Adelphia Commc'ns Corp., 291 B.R. 283, 292 (Bankr. S.D.N.Y.

substantial majority of a debtor's contracts could be terminated by the nondebtor parties, or most creditors were entitled to priority payments or protected from avoidance actions, the utility of chapter 11 would be significantly reduced, if not eliminated.

The Commission voted to exclude ordinary supply agreements from the safe harbors. In reaching this conclusion, the Commissioners emphasized that the exclusion from the safe harbors should be limited to nondealer counterparties' physical supply contracts, including contracts for the supply of natural gas and electricity.

IV. PROPOSED RECOMMENDATIONS: ADMINISTERING THE CASE

A. Executory Contracts and Leases

Section 365 of the Bankruptcy Code generally allows a debtor in possession to assume, assign, or reject executory contracts and unexpired leases in the chapter 11 case.[408] The debtor in possession typically makes this determination based on a variety of factors, including whether the contract or lease is above or below market, necessary to its ongoing business operations, and subject to assumption under the Bankruptcy Code. It also may consult with the unsecured creditors' committee on these issues or attempt to renegotiate the contract or lease with the nondebtor party. A debtor in possession's decision to assume, assign, or reject an executory contract or unexpired lease is subject to court approval, certain deadlines, and several other requirements detailed in section 365.[409]

1. Definition of Executory Contract

Recommended Principles:

- The Bankruptcy Code should define the term "executory contract" for purposes of section 365 as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other," provided that forbearance should not constitute performance. Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973). The contours of this definition are well developed under the case law and reflect an appropriate balance between the rights of a trustee to assume or reject contracts unilaterally under the Bankruptcy Code and the nondebtor's obligations and rights in those circumstances.

2003) (citations omitted). *See also* Theatre Holding Corp. v. Mauro, 681 F.2d 102, 105–06 (2d Cir. 1982); *In re* Enron Corp., 279 B.R. 695, 702 n.8 (Bankr. S.D.N.Y. 2002); *In re* Teligent, Inc., 268 B.R. 723, 738 (Bankr. S.D.N.Y. 2001); *In re* Beker Indus. Corp., 64 B.R. 890, 897 (Bankr. S.D.N.Y. 1986). *But see In re* Enron Corp., 279 B.R. 695, 702 (Bankr. S.D.N.Y. 2002) (noting that "the breathing space afforded to the debtor for the assumption or rejection of executory contract is not without limits.").

[408] 11 U.S.C. § 365.

[409] *See, e.g.*, *id.* § 365(b) (requirements for assumption); *id.* § 365(c) (contracts not subject to assumption or assignment); *id.* § 365(f) (requirements for assignments).

a. Definition of Executory Contract: Background

Section 365(a) provides that a debtor in possession,[410] "subject to the court's approval, may assume or reject any executory contract or unexpired lease of the debtor."[411] The Bankruptcy Code does not define "executory contract," and the legislative history of section 365 provides little guidance.[412] Accordingly, the court on a case-by-case basis determines whether a particular contract is executory.

Courts traditionally have used what is commonly referred to as the "Countryman" definition of executory contracts.[413] This test was developed by Professor Vern Countryman and defines an executory contract for bankruptcy purposes as "a contract under which the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure of either to complete performance would constitute a material breach excusing the performance of the other."[414] Although widely used, courts have recognized limitations and potential inconsistencies in the application of the Countryman test.[415] In addition, the test may not be a good fit for certain kinds of contracts.[416]

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[410] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[411] 11 U.S.C. § 365(a).

[412] H.R. Rep. No. 95-595, at 347 (1977) ("Though there is no precise definition of what contracts are executory, it generally includes contracts on which performance remains due to some extent on both sides.").

[413] *See In re* Baird, 567 F.3d 1207, 1211 (10th Cir. 2009); *In re* Columbia Gas Sys., Inc., 50 F.3d 233, 239 (3d Cir. 1995); *In re* Streets & Beard Farm P'ship, 882 F.2d 233, 235 (7th Cir. 1989); Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1045 (4th Cir. 1985); *In re* Select-A-Seat Corp., 625 F.2d 290, 292 (9th Cir. 1980).

[414] Vern Countryman, *Executory Contracts in Bankruptcy: Part I*, 57 Minn. L. Rev. 439, 460 (1973).

[415] *See, e.g.*, *In re* Gen. Dev. Corp., 84 F.3d 1364, 1374 (11th Cir. 1996); *In re* RoomStore Inc., 473 B.R. 107, 111–12 (Bankr. E.D. Va. 2012).

[416] Some courts have struggled with the application of the Countryman definition in the context of the following kinds of agreements: options and rights of first refusal; restrictive covenants (covenants not to compete; restrictive covenants on land); oil and gas agreements (*e.g.*, the oil and gas leases themselves and variations thereof, like farmout agreements;, and related agreements, like surface use agreements and joint operating agreements); licenses, distributor agreements, and trademark agreements; warranties; rights of first refusal; employment contracts; and severance agreements; arbitration clauses; forum selection clauses; distributor agreements; trademark agreements; and indemnity clauses; and settlement agreements. *See, e.g.*, Water Ski Mania Estates Homeowners Ass'n v. Hayes (*In re* Hayes), 2008 Bankr. LEXIS 4668, at *31–32 (B.A.P. 9th Cir. Mar. 31, 2008) ("[A]lthough restrictive covenants contain the characteristics of both a contract and an interest in land, the primary nature of such covenants is preservation of a land interest, not future duties in contract. Although there will almost always be some incidental continuing obligations under a restrictive covenant, those duties were not the kind of obligations Congress intended to impact in enacting § 365.") (citation omitted); Frontier Energy, LLC v. Aurora Energy, Ltd. (*In re* Aurora Oil & Gas Corp.), 439 B.R. 674, 680 (Bankr. W.D. Mich. 2010) ("The court's conclusion that the [oil and gas leases] qualify as 'leases' within the meaning of Section 365 makes it unnecessary to consider whether the [oil and gas leases] meet either the functional test or Countryman definition for executory contracts. Given the confusion in the case law, it is also improvident to opine on the question.") (citations omitted); *In re* Bergt, 241 B.R. 17, 29–31 (Bankr. D. Alaska 1999) (discussing the application of the Countryman test in recent case law to options); Bronner v. Chenoweth-Massie, P'ship (*In re* Nat'l Fin. Realty Trust), 226 B.R. 586, 589 (Bankr. W.D. Ky. 1998) ("The contingent nature of the obligations arising from an option agreement make them quite distinguishable from the typical contract. This distinction has puzzled many courts, resulting in two distinct lines of cases. The first line of cases, while recognizing the contingent nature of the obligations arising under option agreements, and while also expressly acknowledging that they are unilateral contracts until exercised, have nevertheless engaged in what could be described as analytical gymnasts to arrive at a finding that they are nonetheless executory contracts.") (citations omitted); Cohen v. Drexel Burnham Lambert Grp., Inc. (*In re* Drexel Burnham Lambert Grp., Inc.), 138 B.R. 687,

Given the noted flaws in the Countryman test, courts have developed alternative approaches to assess executoriness. For example, some courts use the "functional approach" to evaluate a debtor in possession's request to assume or reject an executory contract. Under this approach, developed by Professor Jay Westbrook, there is no threshold standard of "executoriness" that the debtor in possession must meet to assume or reject the contract.[417] Rather, the functional approach focuses on whether assumption or rejection would create a benefit for the bankruptcy estate and its creditors. The functional approach recognizes that courts often manipulate the threshold requirement of executoriness in order to produce the desired outcome.[418] Several courts have adopted the functional approach or used it in connection with the Countryman test.[419]

Another alternative approach is commonly referred to as the "exclusionary approach." This approach is a deviation from the Countryman test and was developed by Michael Andrew.[420] The following are the primary differences between the Countryman test and the exclusionary approach: (i) the concept of executoriness is irrelevant in the rejection context;[421] and (ii) a contract is executory if each party has unperformed obligations, and if the debtor's nonperformance eliminates its right to the other party's performance.[422] Although courts have not adopted this approach, they have considered its factors in applying other tests.423[423]

b. Definition of Executory Contract: Recommendations and Findings

The Commission conducted an in-depth review of the literature and case law on executoriness under the Bankruptcy Code. Some of the Commissioners noted their experience with litigation concerning the executoriness issue and the attendant uncertainty and expense. The focus of the executoriness inquiry is whether each party has significant unperformed obligations under the contract.[424] The Commissioners

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699 (Bankr. S.D.N.Y. 1992) ("Our readings persuade us that in each case, use of the Countryman test was neither necessary nor determinative. It was, rather, merely window dressing for results determined in the first instance by resort to another, sometimes unspecified criterion.") (analyzing case law regarding application of Countryman test to employment agreements). *See also infra* note 424.

[417] Jay L. Westbrook, *A Functional Analysis of Executory Contracts*, 74 Minn. L. Rev. 227, 282–85 (1989).

[418] *Id.* at 287.

[419] *See, e.g.*, Route 21 Assoc. of Belleville, Inc., v. MHC, Inc., 486 B.R. 75 (S.D.N.Y. 2012); *In re* Majestic Capital, Ltd., 463 B.R. 289, 300 (Bankr. S.D.N.Y. 2012).

[420] Michael T. Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. Colo. L. Rev. 845 (1988); Michael T. Andrew, *Executory Contracts Revisited: A Reply to Professor Westbrook*, 62 U. Colo. L. Rev. 1 (1991).

[421] Andrew, *Executory Contracts in Bankruptcy*, *supra* note 420, at 894.

[422] *Id.* at 893

[423] *See, e.g., In re* Family Snacks, Inc., 257 B.R. 884, 905 (B.A.P. 8th Cir. 2001).

[424] The Seventh Circuit Court of Appeals explained:

The Bankruptcy Code's legislative history states that the term "executory contract" "generally includes contracts on which performance is due to some extent on both sides.' A common definition, which this court has cited with approval, states that a contract is executory for bankruptcy purposes where "the obligation of both the bankrupt and the other party to the contract are so far unperformed that the failure to complete performance would be a material breach excusing the performance of the other." *In re* Crippin, 877 F.2d 594, 596 (7th Cir. 1989). *See also* Counties Contracting & Constr. Co. v. Constitution Life Ins. Co., 855 F.2d 1054, 1060 (3d Cir. 1988) ("The [Bankruptcy] Code does not define the term executory contract, however, courts have generally employed what has become known as the 'Countryman' definition of an executory contract, *i.e.*, a contract under which the obligations of both

discussed examples of contracts when this issue may be of particular concern, such as options, covenants not to compete, and oil and gas leases.[425] Although executoriness is not necessarily a bright-line determination, the Commissioners generally agreed that courts resolve this issue fairly or parties are able to negotiate a resolution.

The Commission also considered the possibility of eliminating the concept of executoriness from the Bankruptcy Code. Both the advisory committee and the 1997 NBRC endorsed this position.[426] The Commissioners debated at length the potential utility to this approach. They discussed the meaningful benefits to refocusing contract disputes on the merits of the proposed assumption or rejection rather than extensive litigation on executoriness. The Commissioners supporting this approach emphasized the value to such a clean solution: with the distraction of executoriness off the table, parties could devote more attention on their rights, obligations, and remedies under the contract. Many Commissioners found the simplicity of this approach attractive.

Further deliberations about the elimination proposal revealed, however, the potential of unintended consequences of such a dramatic shift in a fundamental bankruptcy principle. The Commissioners noted the common law origins of the executoriness requirement of section 365,[427] and they also perceived value in maintaining some type of gating feature to vet those contracts that a debtor in possession could assume, assign, or reject in the chapter 11 case. Thus, the elimination of the executoriness concept could simply shift, rather than reduce, the amount of litigation or uncertainty in the first instance under section 365. Moreover, many Commissioners believed that the assumption or rejection decision was largely irrelevant to contracts that have already been fully performed by at least one of the parties.

The Commissioners also discussed the functional approach to determining executoriness, but most perceived the test to be unfair toward counterparties and too heavily weighted in favor of the interests of the debtor and the estate. The

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the bankrupt and the other party remain so far unperformed that failure of either to complete performance would constitute a material breach excusing performance of the other.") (citation omitted).

[425] *See, e.g.*, COR Route 5 Co., LLC v. Penn Traffic Co. (*In re* Penn Traffic Co.), 524 F.3d 373, 380 (2d Cir. 2008) ("While some courts have held that options contracts under which the optionee fully paid its price for the option to buy property before the debtor filed for bankruptcy are not executory (because no performance is due from the optionor unless the option is exercised), . . . others treat such contracts as executory.") (citing conflicting case law) (citations omitted); Powell v. Anadarko E&P Co., L.P. (*In re* Powell), 482 B.R. 873, 877–78 (Bankr. M.D. Pa. 2012) ("Some courts have assumed that an oil and gas lease is an executory contract. Other courts have considered an oil and gas lease a transfer of an interest in real property and therefore not an executory contract.") (citing conflicting case law) (citations omitted); *In re* Teligent, Inc., 268 B.R. 723, 730–31 (Bankr. S.D.N.Y. 2001) ("As a rule, Delaware law treats the covenant not to compete and the reciprocal promise to pay as material. As a result, the failure to make payment will discharge the obligation not to compete. . . . Where the covenant is given in connection with the sale of a business, it is even more likely to be deemed material. A covenant not to compete is often included in a contract to sell a business to protect the purchaser and allow him to enjoy the built-up good will.").

[426] *See* NBRC Report, *supra* note 37, at 21 ("Title 11 should be amended to delete all references to 'executory' in section 365 and related provisions, and 'executoriness' should be eliminated as a prerequisite to the trustee's election to assume or breach a contract.").

[427] *See In re* Austin Dev. Co., 19 F.3d 1077, 1081 (5th Cir. 1994) ("Section 365 derives from § 70(b) of the former Bankruptcy Act, a provision that broadly codified the common law doctrine that allowed the trustee either to assume and perform the debtor's leases or executory contracts or to 'reject' them if they were economically burdensome to the estate.").

Commissioners acknowledged the potential value of allowing a debtor in possession to assume or reject any contract that would provide a benefit to the estate. As with the elimination proposal, however, the Commissioners were concerned about diminishing the rights of the nondebtor counterparties under the contracts. Subjecting any contract to section 365 primarily, if not solely, for the benefit of the estate imposed a greater burden on nondebtor parties than necessary to achieve a fair result for the estate in a chapter 11 case.

On balance, the Commission voted to adopt the Countryman test and to recommend its express incorporation into the Bankruptcy Code. The Commission found that, although imperfect, the Countryman test strikes an appropriate balance between the rights of debtors in possession and nondebtor counterparties to a contract. If the parties have material unperformed obligations, it is fair and reasonable to allow a debtor to choose to assume, assign, or reject such an agreement under section 365. The Commission also determined that many of the potentially challenging issues under the Countryman test have been resolved by the courts and that this case law is a valuable resource that would guide the implementation of the codified standard.

2. General Rights of Private Parties to Executory Contracts and Unexpired Leases

Recommended Principles:

- A nondebtor party to an executory contract or unexpired lease with the debtor should be required to continue to perform under such contract or lease after the petition date, provided that the trustee needs such continued performance and pays for any products or services delivered after the petition date on a timely basis as required by the contract or lease. In paying for such products or services, however, the trustee should not be subject to any modifications or rate changes in the contract or lease triggered by the debtor's bankruptcy filing, insolvency, or pre-petition default.
- Except as provided in section 365(d)(3) of the Bankruptcy Code (and the principles for that section, see Section V.A.6, *Real Property Leases*) and in section 365(d)(5) of the Bankruptcy Code, the trustee does not otherwise have an obligation to perform, or to cure any defaults, under such contract or lease prior to the assumption of that contract or lease under section 365(a). The nondebtor party should be permitted to compel the trustee to perform other post-petition obligations under the contract or lease if the court determines, after notice and a hearing, that the harm to the nondebtor party resulting from the trustee's nonperformance significantly outweighs the benefit to the estate derived from such nonperformance. The court should limit the trustee's performance obligation to that which is necessary to mitigate the harm to the nondebtor party pending assumption or rejection. The nondebtor party should bear the burden of proof in any such hearing.
- The trustee should not be required to cure nonmonetary defaults that occur prior to the assumption of the executory contract or unexpired lease and that are impossible for the debtor to cure at the time of the proposed assumption under section 365(a) and (b).

- These principles governing the rights of parties to executory contracts and unexpired leases are intended to apply only to contracts and leases between private parties and should not affect the debtor's contracts or leases with any state or federal governments.

a. General Rights of Private Parties to Executory Contracts and Unexpired Leases: Background

In most chapter 11 cases, the debtor in possession[428] does not make its decision to assume, assign, or reject executory contracts and unexpired leases on, or even shortly after, the petition date. As such, there is a gap period between the petition date and the treatment decision under section 365. The Bankruptcy Code requires the debtor in possession to perform timely obligations arising under nonresidential real property leases, certain personal property leases,[429] and intellectual property licenses,[430] but does not otherwise address performance during the gap period.[431] In light of this silence, "most courts agree that before an executory contract is assumed or rejected under section 365(a), that contract continues to exist, enforceable by the debtor in possession, but not enforceable against the debtor in possession."[432]

Courts generally justify this one-sided performance requirement by emphasizing the importance of the breathing spell created by the automatic stay for the debtor in possession,[433] and the severe consequences that may result from a rushed or premature decision to assume, assign, or reject an executory contract or unexpired lease.[434] They also acknowledge the burden such one-sided performance may impose on the nondebtor party, but on balance find in favor of the estate. The nondebtor party may seek to compel performance or a treatment decision by the debtor in possession under section

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[428] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[429] 11 U.S.C. § 365(d)(5). This provision for personal property leases applies only in chapter 11 cases. *Id.* If the case is initially filed under chapter 11 and later converted to chapter 7, section 365(d)(5) will no longer apply. 3 Collier on Bankruptcy ¶ 365.04[2][c].

[430] 11 U.S.C. § 365(n).

[431] *Id.* § 365(d)(3). The court "may extend, for cause, the time for performance of any such obligation that arises within 60 days after the date of the order for relief, but the time for performance shall not be extended beyond such 60-day period." *Id.*

[432] *See, e.g., In re* Nat'l Steel Corp., 316 B.R. 287, 305 (Bankr. N.D. Ill. 2004) (collecting cases). *See also* Howard C. Buschman III, *Benefits and Burdens: Post-petition Performance of Unassumed Executory Contracts*, 5 Bankr. Dev. J. 341, 343 (1988) (citing Douglas Bordewieck & Vern Countryman, *The Rejection of Collective Bargaining Agreements by Chapter 11 Debtors*, 57 Am. Bankr. L.J. 239, 332 (1983)); 2 Collier on Bankruptcy ¶ 365.03, 365-28, 365-29 (15th ed. 1988); 8 Collier on Bankruptcy ¶ 3.15(6) at 204 (14th ed. 1978).

[433] *See, e.g., In re* Cont'l Energy Assocs. Ltd. P'ship, 178 B.R. 405, 408 (Bankr. M.D. Pa. 1995) ("Not only does this saddle an ailing company with an additional burden which it is unlikely to overcome, it pressures the Debtor to surrender the 'breathing space' normally allowed to it to consider the assumption or rejection of the contract.").

[434] 11 U.S.C. § 365(g)(2). Post-assumption rejection is treated as a breach at the time of rejection (*i.e.*, post-petition). *Id.* Where a contract or lease is assumed in a chapter 11 case that is later converted to a chapter 7 and then the contract or lease is rejected in the chapter 7 case, the rejection would be treated as having occurred immediately before the date of conversion. 1 Collier Handbook for Trustees & Debtors in Possession ¶ 14.07 (2012).

365, and it frequently requests an administrative claim under section 503(b)(3) for any post-petition obligations that the debtor in possession fails to perform.[435]

Once a debtor in possession decides to assume an executory contract or unexpired lease, section 365(b) requires the debtor in possession to cure or provide adequate assurance of a prompt cure of any defaults under the contract or lease. Section 365(b)(1) indicates that nonmonetary defaults that are impossible to cure under unexpired leases for nonresidential real property do not require cure, "except that if such default arises from a failure to operate in accordance with a nonresidential real property lease, then such default shall be cured by performance at and after the time of assumption in accordance with such lease, and pecuniary losses resulting from such default shall be compensated in accordance with the provisions of this paragraph."[436] Section 365(b)(2) further provides that a debtor in possession's general cure obligations under section 365(b)(1) do not apply to "the satisfaction of any penalty rate or penalty provision relating to a default arising from any failure by the debtor to perform nonmonetary obligations under the executory contract or unexpired lease."[437] Some courts have interpreted section 365 to preclude the assumption of executory contracts and unexpired leases (other than real property leases) if non-curable historical nonmonetary defaults exist under the contract or lease.[438]

b. General Rights of Private Parties to Executory Contracts and Unexpired Leases: Recommendations and Findings

The chapter 11 filing can have significant negative implications for a nondebtor party's business. Accordingly, the Commission carefully scrutinized the post-petition needs of a debtor in possession with respect to executory contracts and unexpired leases. The Commissioners discussed the importance of a reliable, steady supply of goods and services used in the debtor's business to the debtor in possession's reorganization efforts. They also acknowledged that nondebtor parties frequently threaten to stop providing goods or services unless the debtor in possession satisfies certain conditions. Although the Commissioners understood the nondebtor party's desire for more certainty and for some kind of adequate assurance, they found the general principles underlying the post-petition performance requirements to be sound.

Reflecting on the circumstances of nondebtor parties in these cases, however, the Commissioners considered various ways to mitigate the burden imposed by the general post-petition performance requirement. They did not believe that the debtor in possession should be required to provide adequate protection under section 361 of the

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[435] 11 U.S.C. § 503(b). The extent of the nondebtor party's administrative claim, however, may be limited by the court under the "benefit to the estate" standard of section 503(b). *See* Mason v. Official Comm. of Unsecured Creditors (*In re* FBI Distrib. Corp.), 330 F.3d 36, 42–43 (1st Cir. 2003) ("[T]he nondebtor party will be entitled to administrative priority only to the extent that the consideration supporting the claim was supplied to the debtor in possession during the reorganization and was beneficial to the estate."); *In re* Nat'l Steel Corp., 316 B.R. 287, 301 (Bankr. N.D. Ill. 2004) ("Claims under § 503(b)(1)(A) are to be measured by the benefit received by the estate rather than the cost incurred by a claimant.").

[436] 11 U.S.C. § 365(b)(1).

[437] *Id.* § 365(b)(2).

[438] *See, e.g.*, *In re* Carterhouse, Inc., 94 B.R. 271, 273 (Bankr. D. Conn. 1988) (holding that section 365(b)(1) "extends to nonmonetary as well as monetary breaches").

Bankruptcy Code or to cure any historical defaults prior to assumption or rejection of the contract or lease. They also rejected full performance of the contract or lease by the debtor in possession, agreeing with courts that hold such a requirement undercuts the value of the automatic stay in the debtor in possession's reorganization efforts.

The Commissioners debated the feasibility of requiring the debtor in possession to pay for goods and services actually provided to the debtor in possession post-petition in accordance with the terms of the contract or lease. Some Commissioners commented that the debtor in possession may not have the liquidity to meet this standard on an immediate post-petition basis, while others indicated that the debtor in possession's needs in this respect could be factored into the post-petition financing budget.[439] The Commissioners stressed the need for any such payment obligation to be limited to those goods and services needed by, and provided to, the debtor in possession post-petition and that the nondebtor party should not be able to enforce more onerous payment terms from, or demand any other type of performance of, the debtor in possession pending assumption or rejection of the contract or lease.[440] The terms of the pre-petition contract or lease should govern the timing and amount of the debtor in possession's post-petition payment obligations, unless the parties mutually agree to more beneficial terms for the estate.

The Commissioners also analyzed the circumstances under which nondebtor parties should be able to seek to compel full or greater post-petition performance by the debtor in possession under the contract or lease. The Commissioners generally believed that nondebtor parties should have this option, but that the standard of proof should be stringent and that the nondebtor party should bear the burden of proof, particularly in light of the Commission's recommendation to require some post-petition payment by the debtor in possession. The Commission ultimately determined that this standard was an appropriate balance and recommended the joint proposal of requiring payment solely for goods or services provided to the debtor in possession post-petition and placing a high evidentiary burden on the nondebtor party that seeks to compel further or other post-petition performance. The Commissioners also discussed the potential impact of these provisions on government contracts. In light of the different and varied interests that may be implicated by government contracts, the Commission agreed that these contracts be excluded from the recommended principles governing post-petition performance of executory contracts and unexpired leases and that such principles be limited to the rights of private parties to executory contracts and unexpired leases with a debtor.

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[439] Some of the Commissioners proposed incorporating an "adequate assurance" concept similar to Section 2-609 of the Uniform Commercial Code, but others believed that this would provide too much leverage for counterparties in terms of holdup value.

[440] *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–4 (June 4, 2013) (stating that retailers are failing because of the reluctance of trade creditors to extend credit on reasonable terms and the difficulty of obtaining DIP and exit financing to support reorganization), *available at* Commission website, *supra* note 55; *id.* at 5 (citing the January 2013 Senior Loan Officer Opinion Survey on Bank Practices from the Federal Reserve which indicates that DIP lending is tight and trade vendors are unwilling to extend credit except on onerous terms).

Finally, the Commissioners addressed the continued confusion in the case law concerning a debtor in possession's obligation to cure historical nonmonetary defaults in order to assume the executory contract or unexpired lease. The Commissioners acknowledged that the BAPCPA Amendments to the Bankruptcy Code clarified this issue for real property leases, but that ambiguity remained for other kinds of leases and executory contracts. The Commissioners debated whether certain kinds of historical nonmonetary defaults were so central to a contract's or lease's purpose that their nonperformance should bar assumption. On balance, the Commission determined that, with respect to all executory contracts and unexpired leases, a debtor in possession should not be required to cure nonmonetary defaults occurring prior to the assumption decision that are impossible to cure at the time of assumption under section 365(b) of the Bankruptcy Code.

3. Rejection of Executory Contracts and Unexpired Leases

Recommended Principles:

- The rejection of an executory contract or unexpired lease should continue to constitute a breach of the contract or lease as of the time immediately preceding the commencement of the case under section 365(g) of the Bankruptcy Code. The trustee's rejection of an executory contract or unexpired lease should not, however, entitle the nonbreaching, nondebtor party to a right of specific performance or to retain possession or use of any property of the debtor or the estate.
- A nonbreaching, nondebtor party should be able to retain possession or continue to use property of the debtor or the estate if expressly authorized by a section of the Bankruptcy Code (e.g., section 365(n)).
- If the nondebtor party to an executory contract or unexpired lease breaches the executory contract or unexpired lease prior to the trustee's assumption or rejection decision, the trustee may treat such contract or lease as breached and exercise any rights or remedies it may have under the contract or lease or applicable nonbankruptcy law.

a. Rejection of Executory Contracts and Unexpired Leases: Background

A debtor in possession[441] may reject (i.e., disavow) most executory contracts and unexpired leases under section 365(a) of the Bankruptcy Code. A debtor in possession's decision to reject an executory contract or unexpired lease generally relieves the debtor in possession of further performance obligations under the contract or lease. Courts, however, have differed on whether rejection terminates the contract or lease or, rather, constitutes a breach by the debtor in possession of such contract or lease.

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[441] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

Section 365(g) of the Bankruptcy Code specifically provides that rejection "constitutes a breach of such contract or lease." As such, section 365(g) answers the initial question concerning the effect of rejection and expressly equates rejection with a breach of the contract or lease by the debtor.[442] In some cases, that determination may end the inquiry, but in other cases, questions still remain regarding what rights the nondebtor party may pursue under the contract or lease or under applicable nonbankruptcy law because of the debtor's breach. As explained by the Seventh Circuit in *Sunbeam Products, Inc. v. Chicago American Manufacturing, LLC*,

> [w]hat section 365(g) does by classifying rejection as breach is establish that in bankruptcy, as outside of it, the other party's rights remain in place. After rejecting a contract, a debtor is not subject to an order of specific performance. . . . The debtor's unfulfilled obligations are converted to damages; . . . But nothing about this process implies that any rights of the other contracting party have been vaporized.[443]

Courts and commentators agree that rejection gives the nondebtor party a right to assert monetary damages against the debtor in possession, which is deemed a pre-petition claim against the estate.[444] They also generally agree that the nondebtor party cannot compel continued performance by the debtor in possession, unless otherwise specifically permitted by section 365.[445] They do not, however, agree whether the nondebtor party can enforce equitable remedies against the debtor in possession that such party otherwise would be able to assert under applicable nonbankruptcy law.[446] The court's perspective on this issue can have significant implications for the estate.

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[442] *See, e.g.*, Sunbeam Prod., Inc. v. Chi. Am. Mfg, LLC, 686 F.3d 372 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012). Both the National Bankruptcy Conference's Bankruptcy Code Review Project in 1993 and the NBRC in 1997 expressly considered the question of whether rejection should result in termination and provided a negative answer. A.L.I.-A.B.A., Bankruptcy Reform Circa 1993 183–87 (Nat'l Bankr. Conf. 1993); NBRC Report, *supra* note 37, § 2.4.1.

[443] Sunbeam Prod., Inc. v. Chi. Am. Mfg, LLC, 686 F.3d 372, 377 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012).

[444] 11 U.S.C. § 365(g)(1).

[445] *See, e.g., In re* Walnut Assocs., 145 B.R. 489, 494 (Bankr. E.D. Pa. 1992) ("[N]on-debtor party to the contract subject to rejection is limited in its claims for breach to the treatment accorded to a debtor's general unsecured creditors. . . . [U]nless specific performance is available to the non-debtor party under applicable state law, the debtor cannot be compelled to render its performances required under the contract. However, if state law does authorize specific performance under the rejected executory contract, it means that the non-debtor should be able to enforce the contract against the Debtor, irrespective of his rejection of it.").

[446] *See, e.g.*, Abboud v. Ground Round, Inc. (*In re* Ground Round, Inc.), 335 B.R. 253 (B.A.P. 1st Cir. 2005) ("[A] party is entitled to specific performance of a rejected executory contract if such remedy is clearly available under applicable state law."); *In re* Annabel, 263 B.R. 19 (Bankr. N.D.N.Y. 2001) (same with respect to covenant not to compete). *But see, e.g., In re* Register, 95 B.R. 73, 75 (Bankr. M.D. Tenn. 1989) (refusing to enforce covenant not to compete in rejected sale agreement). *See also* Route 21 Assoc. of Belleville, Inc. v. MHC, Inc., 486 B.R. 75 (S.D.N.Y. 2012) (injunctive relief could be reduced to monetary claim).

b. Rejection of Executory Contracts and Unexpired Leases: Recommendations and Findings

The Commission focused a substantial amount of time on the concept of rejection and whether a debtor in possession's decision to reject an executory contract or unexpired lease should trigger a breach or termination of such contract or lease. The Commissioners discussed the language of section 365 and specifically contrasted it with the chapter 5 avoiding powers of the debtor in possession. Congress did not intend section 365 to operate as an avoiding power that would allow a debtor in possession to terminate or unwind pre-petition agreements or completely extinguish the rights of the nondebtor counterparty to an agreement. Such a result would be contrary to the language and structure of the Bankruptcy Code and well-settled federal policy that state law generally determines property rights in bankruptcy.[447] The Commission voted to reinforce the principle that rejection of an executory contract or unexpired lease constitutes a breach, not a termination, of such contract or lease.

The Commissioners fully vetted the potential consequences of equating rejection with breach of the applicable contract or lease, using various examples to explore the nuances and variances in possible results. In analyzing these scenarios, the Commissioners worked to balance the state law rights and interests of the nondebtor party with the federal interests that are central to the reorganization efforts of a debtor in possession. These federal interests include equal treatment of all similarly situated creditors, automatic stay of actions based on pre-petition transactions and relationships with the debtor, and the ability of the debtor in possession to reject burdensome contracts and leases to facilitate its reorganization.[448]

The Commission considered the rejection of different kinds of contracts and leases, and identified the competing interests of the debtor in possession and the nondebtor, and the needs of the estate, following rejection. For example, the debtor in possession, on behalf of the estate, needs (i) any property that may be held by the nondebtor party to be returned; (ii) the ability to use such property free from restraints or limitations; and (iii) relief from any performance obligations under the contract or lease. Congress was aware of these needs and carefully balanced them against the interests of the nondebtor party. In specific instances when the interests of the nondebtor party outweigh the needs of the debtor in possession, Congress specified the nondebtor party's rights upon

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[447] "Property interests are created and defined by state law. Unless some federal interest requires a different result, there is no reason why such interests should be analyzed differently simply because an interested party is involved in a bankruptcy proceeding." Butner v. United States, 440 U.S. 48, 54 (1979).

[448] *See, e.g.*, *In re* Am. Suzuki Motor Corp., 494 B.R. 466, 477 (Bankr. C.D. Cal. 2013) ("The purpose of contract rejection under section 365 is to permit the debtor to receive the economic benefits necessary for reorganization (which includes liquidation under chapter 11) for the ultimate benefit of the estate and its creditors. State legislatively imposed buyback requirements, fair market value awards and treble-damages penalties are superimposed onto the normal contract damage remedy provisions under state common or statutory law. While Florida and many other states believe that their public policy should provide special protections for the economic interest of local car dealerships, in the area of federal bankruptcy law those remedies run counter to the federal policy of bankruptcy reorganization and are therefore preempted."); *In re* PPI Enters. (U.S.), Inc., 228 B.R. 339, 344–45 (Bankr. D. Del. 1998) ("In enacting the Bankruptcy Code, Congress made a determination that an eligible debtor should have the opportunity to avail itself of a number of Code provisions which adversely alter creditors' contractual and nonbankruptcy law rights.").

rejection. Specifically, these exceptions arise in the context of certain real property leases, timeshares, and intellectual property licenses.[449]

The Commission agreed that, other than the exceptions already made by Congress, the nondebtor party to the rejected contract or lease should be required to immediately return the debtor's property to the debtor in possession and should not be able to enforce any equitable or injunctive relief against, or otherwise require performance by, the debtor in possession. In addition to the factors previously noted, the Commissioners pointed to section 542 in support of requiring the counterparty to return personal property to the estate upon rejection.[450] They also believed that allowing the nondebtor party to enforce equitable or injunctive relief against the debtor in possession would elevate the rights of such counterparty beyond those of other similarly situated pre-petition creditors. Indeed, general unsecured creditors typically are not entitled to relief from the automatic stay or to take actions affecting the debtor in possession's post-petition business operations, despite the terms of the creditors' pre-petition contracts or applicable nonbankruptcy law. Accordingly, the Commission endorsed the conclusions that rejection should constitute a breach, but it should not (i) deprive the debtor in possession of the right to possess or use estate property or (ii) require specific performance by the debtor in possession or the estate.

4. Intellectual Property Licenses

Recommended Principles:

- A trustee should be able to assume an intellectual property license in accordance with section 365(a) of the Bankruptcy Code notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement.
- The trustee should be able to assign an intellectual property license to a single assignee in accordance with section 365(f) notwithstanding applicable nonbankruptcy law or a provision to the contrary in the license or any related agreement. If the trustee seeks to assign an intellectual property license under which the debtor is a licensee to a competitor of the nondebtor licensor or an affiliate of such competitor, the court may deny the assignment if the court determines, after notice and a hearing, that the harm to the nondebtor licensor resulting from the proposed assignment significantly outweighs the benefit to the estate derived from the assignment. The nondebtor licensor should bear the burden of proof in any such hearing.
- Foreign patents and copyrights should be included within the definition of "intellectual property" set forth in section 101(35A) and subject to section 365, including section 365(n). In addition, foreign trademarks should also be included in this definition, subject to the limitations and conditions imposed on

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[449] 11 U.S.C. § 365(h), (i), (n).

[450] *Id.* § 542(a) ("[A]n entity . . . shall deliver to the trustee, and account for, such property or the value of such property, unless such property is of inconsequential value or benefit to the estate.").

domestic trademarks under the recommended principles in Section V.A.5, *Trademark Licenses.*

a. Intellectual Property Licenses: Background

A debtor's or the estate's assets often include intellectual property. The Bankruptcy Code defines "intellectual property" as a "(A) trade secret; (B) invention, process, design, or plant protected under title 35 [of the U.S. Code; (C) patent application; (D) plant variety; (E) work of authorship protected under title 17 [of the U.S. Code]; or (F) mask work protected under chapter 9 of title 17; to the extent protected by applicable nonbankruptcy law."[451] In the context of section 365 of the Bankruptcy Code, debtors in possession[452] commonly face issues with respect to their ability to assume, assign, or reject their intellectual property licenses.[453]

A "license" is an agreement that generally allows an owner to monetize the value of its intellectual property. Licenses permit, often for a fee, a third party (licensee) to use the owner's (licensor's) intellectual property for a specified purpose, within a specified geographic region, for a specified time period, under specified conditions. Licenses range on a sliding scale from conferring very limited nonexclusive rights to all or essentially all rights to the intellectual property. Licenses are, in essence, a form of covenant by which the licensor agrees not to sue the licensee for using the licensor's intellectual property.

When a debtor in possession is the licensee under an intellectual property license, two potentially competing federal interests are at play: (i) the Bankruptcy Code generally allows the debtor in possession to unilaterally decide whether to assume, assign, or reject an executory contract; and (ii) the federal law on intellectual property licenses respects the right of the licensor to control its intellectual property.[454] Some courts have turned to section 365(c) of the Bankruptcy Code to address this potential conflict. Section 365(c) generally restricts the ability of a debtor in possession to assume or assign if "applicable law excuses a party, other than the debtor, to such contract or lease from accepting performance from or rendering performance to an entity other than the debtor or the debtor in possession, whether or not such contract or lease prohibits or restricts assignment of rights or delegation of duties."[455] Such contracts can be assumed or assigned by the debtor in possession only with the consent of the nondebtor party to the contract.

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[451] 11 U.S.C. § 101(35A).

[452] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[453] Courts generally characterize intellectual property licenses as executory contracts. *In re* Kmart Corp., 290 B.R. 614, 618 (Bankr. N.D. Ill. 2003) ("Generally speaking, a license agreement is an executory contract as such is contemplated in the Bankruptcy Code.'") (citations omitted).

[454] *See* Unarco Indus., Inc. v. Kelley Co., Inc., 465 F.2d 1303, 1306 (7th Cir. 1972), *cert. denied*, 410 U.S. 929 (1973) (citations omitted) ("[L]ong standing federal rule of law with respect to the assignability of patent licenses provides that these agreements are personal to the licensee and not assignable unless expressly made so in the agreement.").

[455] 11 U.S.C. § 365(c)(1).

Courts applying section 365(c)(1) to the rights of a debtor in possession as a licensee under an intellectual property license are split regarding whether a debtor in possession may assume (i.e., keep and perform under) the license, as opposed to assigning the license to a third party, without the consent of the nondebtor licensor. Courts that permit a debtor in possession to assume a license under these circumstances follow the "actual approach," which treats the debtor in possession as the same entity to which the third party licensor extended the license in the first instance.[456] Because the identity of the parties has not changed under this theory and the action would not be deemed an impermissible assignment under applicable nonbankruptcy law, these courts authorize the debtor in possession to assume such license under section 365(a) and (b).

Other courts, however, find the actual test in contravention of the statutory language. These courts follow the "hypothetical approach," which preclude the debtor in possession from assuming an agreement if applicable nonbankruptcy law would preclude the debtor from assigning the license to a third party, even if the debtor in possession has no intention of effecting such an assignment.[457] Some commentators have criticized the hypothetical approach as providing the nondebtor licensor with holdup power that can frustrate or completely derail the reorganization efforts of the debtor in possession.[458]

Conversely, when a debtor in possession is the licensor under an intellectual property license and decides to reject the license, section 365(n) of the Bankruptcy Code allows the nondebtor licensee to treat the license as either (i) terminated, or (ii) effective through the end of the remaining term. If the licensee elects to retain the license, it cannot compel any performance by the debtor, but it retains the ability to use certain of its rights under the license for the remaining term, for which it must continue to pay any royalties or other fees required by the terms of the license. Additionally, the nondebtor licensee may assert any damages for nonperformance by the debtor through a setoff against any fees or payments it owes under the license. Notably, the definition of intellectual property does not include foreign intellectual property or trademarks, which often poses an issue under section 365(n). In the context of trademarks, the issue is particularly challenging when the trademarks are integrated into a license with intellectual property (as that term is currently defined under the Bankruptcy Code). The treatment of trademarks under section 365 is addressed separately in the following section.

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[456] The First and Fifth Circuits adopted the "actual test." *In re* Mirant Corp., 440 F.3d 238 (5th Cir. 2006); Institut Pasteur v. Cambridge Biotech Corp., 104 F.3d 489 (1st Cir. 1997), *abrogated by* Hardemon v. City of Boston, 1998 WL 148382 (1st Cir. Apr. 6, 1998), *superseded by* 144 F.3d 24 (1st Cir. 1998). *See also In re* Footstar, Inc., 323 B.R. 566 (Bankr. S.D.N.Y. 2005) (taking a slightly different approach but holding that section 365(c)(1)'s use of the word "trustee" does not include the debtor or debtor in possession when assumption is sought because assumption does not require the nondebtor party to accept performance from a new party other than the debtor or debtor in possession).

[457] The Third, Fourth, Ninth, and Eleventh Circuits have adopted the "hypothetical test." *In re* Sunterra Corp., 361 F.3d 257 (4th Cir. 2004); *In re* Catapult Entm't, Inc., 165 F.3d 747 (9th Cir. 1999); *In re* James Cable Partners, L.P., 27 F.3d 534 (11th Cir. 1994); *In re* West Elec. Inc., 852 F.2d 79 (3d Cir. 1988).

[458] *See, e.g.*, David R. Kuney, *Intellectual Property in Bankruptcy Court: The Search for a More Coherent Standard in Dealing with a Debtor's Right to Assume and Assign Technology Licenses*, 9 Am. Bankr. Inst. L. Rev. 593 (2001).

b. Intellectual Property Licenses: Recommendations and Findings

Intellectual property licenses can represent valuable assets of the estate and may be necessary to the reorganization of the debtor in possession. Thus, the treatment of these licenses under section 365 of the Bankruptcy Code is often a critically important issue in the case. The Commission reviewed open issues relating to intellectual property licenses in chapter 11.

The Commissioners evaluated the statutory interpretation and practical issues raised by the debate between supporters of the hypothetical approach, on the one hand, and supporters of the actual approach, on the other hand, concerning the ability of a debtor in possession (as licensee) to assume (i.e., keep and use) an intellectual property license without the consent of the nondebtor party (as licensor).[459] The Commissioners acknowledged that nondebtor licensors may have legitimate concerns about providing their intellectual property to a party other than the debtor, but those concerns should not exist when the debtor in possession proposes to assume and perform in accordance with the license. In those instances, the licensor would be receiving the benefit of its bargain. The Commissioners recognized that application of the hypothetical test results in artificial barriers to the reorganization of the debtor in possession — an outcome that directly undercuts a fundamental policy underlying the Bankruptcy Code. The Commission voted to reject the hypothetical approach and to adopt and codify the actual approach. The Commission further recommended that Congress amend the Bankruptcy Code to expressly authorize the debtor in possession to assume executory intellectual property licenses.

The Commissioners also critically analyzed whether the result of the hypothetical test (i.e., no assumption without the consent of the nondebtor licensor) was good policy in the actual assignment context. Admittedly, the ability to exclude others from using your intellectual property is a key element of intellectual property ownership. This right provides intellectual property owners some control over the use of their property and a means to monetize at least some of the value of their property. The assignment by the debtor in possession of an intellectual property license, in accordance with the terms of section 365(f) (requiring, among other things, adequate assurance of future performance and assumption of the entire agreement), arguably does not significantly decrease the value of the licensor's right to exclude users.

The Commissioners debated the advantages and disadvantages of providing debtors in possession with more flexibility to assign intellectual property licenses under the Bankruptcy Code. Some of the Commissioners believed that this flexibility was necessary to maximize the value of the estate and to facilitate certain reorganization transactions. In considering the value of the license from both the licensor's and licensee's perspectives, they observed that U.S. assignment laws are more restrictive

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[459] *See Written Statement of Robert L. Eisenbach III, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–6 (June 4, 2013) (discussing the tests in practical terms), *available at* Commission website, *supra* note 55; *Written Statement of Lisa Hill Fenning, Partner, Arnold & Porter LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–6 (June 4, 2013) (discussing impact of bankruptcy law on intellectual property licenses), *available at* Commission website, *supra* note 55.

than those in many foreign jurisdictions.[460] Moreover, many of the Commissioners did not believe that the identity of the debtor, absent unusual circumstances, was *per se* a critical factor in the licensing relationship. Rather, factors such as the licensee's ability to pay, to maintain the desired integrity and quality of the intellectual property, and to comply with all obligations imposed by the license are likely more relevant and important.

The Commissioners acknowledged that the identity of the licensee could be critical if the proposed assignee was a competitor of the licensor. In those instances, nondebtor licensors should have the ability to block a proposed assignment by the debtor licensee. The Commission supported a proposal that would permit a debtor in possession to assign an intellectual property license freely under section 365(f)(1) and (2), subject to a nondebtor licensor's right to demonstrate that the hardship imposed on it by the proposed assignment to one of its competitors would significantly outweigh the benefit to the estate.

The Commission also reviewed the exclusion of foreign patents and copyrights from the definition of intellectual property in section 101(35A) of the Bankruptcy Code. Foreign patents and copyrights are excluded from this definition because they are not covered by title 35 or title 17 of the U.S. Code. The Commissioners believed that licenses for foreign patents, copyrights and trademarks (subject to the limitations proposed for U.S. trademarks below), although generally not governed by U.S. law, should receive the same treatment in bankruptcy as U.S. licenses. Moreover, licensees under licenses of foreign intellectual property should receive the same protections as licensees under U.S. licenses pursuant to section 365(n) of the Bankruptcy Code. The Commission found no reasonable basis for treating foreign intellectual property differently.

5. Trademark Licenses

Recommended Principles:

- "Trademarks," "service marks," and "trade names," as defined in section 1127 of title 15 of the U.S. Code, should be included in the definition of "intellectual property" under the Bankruptcy Code. Section 101(35A) of the Bankruptcy Code should be amended accordingly.
- If a debtor is a licensor under a trademark, service mark, or trade name license and the trustee elects to reject that license under section 365, section 365(n) should apply to the license, with certain modifications. The nondebtor licensee should be required to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed trademark, service mark, or trade name; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed trademark, service mark, or trade name. The

[460] *See, e.g.*, M. Reutter, *Intellectual Property Licensing Agreements and Bankruptcy*, *in* Research Handbook On Intellectual Property Licensing 281 (Jacques de Werra ed., 2013).

> trustee should maintain the right to oversee and enforce quality control for such products or services and should not be under any continuing obligation to provide products or services to the rejected licensee. In addition, the concept of "royalty payments" under section 365(n) should be expanded to include "other payments" contemplated by the trademark, service mark, or trade name license.

a. Trademark Licenses: Background

As noted above, trademarks are not included in the definition of "intellectual property" under section 101(35A) of the Bankruptcy Code. Congress made the conscious decision in the 1988 amendments to exclude this kind of intangible property because trademarks have slightly different characteristics as compared to other intangible property that is included in the definition of intellectual property. One key difference is that any transfer of a trademark, including a license or assignment, must include a transfer of the associated business operations (referred to as "good will" under applicable nonbankruptcy law).[461] In addition, trademark licenses raise other challenges, as explained by the legislative history of Bankruptcy Code section 365(n):

> [T]he bill does not address the rejection of executory trademark, trade name or service mark licenses by debtor licensors. While such rejection is of concern because of the interpretation of section 365 by the *Lubrizol* court and others, such contracts raise issues beyond the scope of this legislation. In particular, trademark, trade name and service mark licensing relationships depend to a large extent on control of the quality of the products or services sold by the licensee. Since these matters could not be addressed without more extensive study, it was determined to postpone congressional action in this area and to allow the development of equitable treatment of this situation by bankruptcy courts.[462]

Several commentators have discussed the uncertainty created for nondebtor licensees of a debtor's trademarks given the exclusion of trademarks from the definition

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[461] The relevant portion of the Lanham Act provides:

> (1) A registered mark or a mark for which an application to register has been filed shall be assignable with the good will of the business in which the mark is used, or with that part of the good will of the business connected with the use of and symbolized by the mark. Notwithstanding the preceding sentence, no application to register a mark under section 1051(b) of this title shall be assignable prior to the filing of an amendment under section 1051(c) of this title to bring the application into conformity with section 1051(a) of this title or the filing of the verified statement of use under section 1051(d) of this title, except for an assignment to a successor to the business of the applicant, or portion thereof, to which the mark pertains, if that business is ongoing and existing.
>
> (2) In any assignment authorized by this section, it shall not be necessary to include the good will of the business connected with the use of and symbolized by any other mark used in the business or by the name or style under which the business is conducted.

15 U.S.C. § 1060(a).

[462] S. Rep. No. 100–505, at 5 (1988), *reprinted in* 1988 U.S.C.C.A.N. 3204 (citations omitted).

of intellectual property and section 365(n). Courts have struggled with the treatment of trademark licenses and the consequences of rejection pursuant to section 365 by a debtor licensor of a license with a nondebtor licensee.[463] Some courts have determined that the rejection of such an agreement terminates the nondebtor licensee's rights to use the relevant trademarks and any associated goodwill, and grants the nondebtor party only the right to file a claim for monetary damages against the estate.[464] Other courts have determined that the debtor in possession's[465] rejection of a license constitutes only a breach of such agreement, which is consistent with section 365(g), and that the nondebtor licensee may continue to exercise its rights under the rejected agreement consistent with applicable nonbankruptcy law.[466] In addition, some courts have determined that trademark licenses are not executory contracts and therefore cannot be rejected.[467]

Similar to other intellectual property, a trademark license may be an integral component of a nondebtor's business — particularly in the franchising context. In the event that a licensor files for bankruptcy, a bankruptcy provision that automatically strips the nondebtor licensee of all rights to use the debtor's trademarks and any associated goodwill upon the debtor in possession's rejection of the trademark license could devastate the nondebtor's business. Conversely, the ability of the debtor in possession to reorganize successfully may hinge, at least in part, on its ability to repossess its trademarks and any associated goodwill and then redeploy these assets in a more productive manner consistent with its reorganization efforts.

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[463] *See, e.g.*, *In re* Old Carco LLC, 406 B.R. 180, 211 (Bankr. S.D.N.Y. 2009), *aff 'd sub nom.* Mauro Motors Inc. v. Old Carco LLC, 420 F. App'x 89 (2d Cir. 2011) ("Trademarks are not 'intellectual property' under the Bankruptcy Code . . . [, so] rejection of licenses by licensor deprives licensee of right to use trademark. . . ."); *In re* HQ Global Holdings, Inc., 290 B.R. 507, 513 (Bankr. D. Del. 2003) ("[S]ince the Bankruptcy Code does not include trademarks in its protected class of intellectual property, *Lubrizol* controls and the Franchisees' right to use the trademark stops on rejection."); *In re* Centura Software Corp., 281 B.R. 660, 674–75 (Bankr. N.D. Cal. 2002) ("Because Section 365(n) plainly excludes trademarks, the court holds that [licensee] is not entitled to retain any rights in [licensed trademarks] under the rejected . . . Trademark Agreement.").

[464] *See* Lubrizol Enters., Inc. v. Richmond Metal Finishers, Inc., 756 F.2d 1043, 1048 (4th Cir. 1985) (no right to continue to use mark upon rejection). Such a claim is treated as an unsecured prepetition claim.

[465] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[466] *See* Sunbeam Prods., Inc. v. Chi. Am. Mfg., LLC, 686 F.3d 372, 377 (7th Cir. 2012), *cert. denied*, 133 S. Ct. 790 (2012) (holding that *Lubrizol* was wrongly decided and that the transfer of rights embodied in trademark or other IP licenses could not be "vaporized" by rejection). "[R]ejection is not the 'functional equivalent of a rescission, rendering void the contract and requiring that the parties be put back in the position they occupied before the contract was formed.' It 'merely frees the estate from the obligation to perform' and 'has absolutely no effect upon the contract's continued existence.'" *Id.* (citations omitted).

[467] *See also In re* Exide Techs., 607 F.3d 957 (3d Cir. 2010) (trademark license not executory and not subject to rejection under facts of case). Courts may use § 365 to free a bankrupt trademark licensor from burdensome duties that hinder its reorganization. They should not — as occurred in this case — use it to let a licensor take back trademark rights it bargained away. This makes bankruptcy more a sword than a shield, putting debtor-licensors in a catbird seat they often do not deserve. *Id.* at 967–68. *But see In re* New York City Shoes, Inc., 84 B.R. 947, 960 (Bankr. E.D. Pa. 1988) (exclusive trademark licensing agreement providing for annual royalties was executory).

b. Trademark Licenses: Recommendations and Findings

The Commission considered whether adding trademarks to the definition of intellectual property under section 101(35A) of the Bankruptcy Code was a workable solution. Several Commissioners noted that the concerns underpinning the decision by Congress in the 1988 amendments to exclude trademarks from the definition of intellectual property still persist. Generally, applicable nonbankruptcy law continues to treat trademarks differently in comparison to other intangible property. These Commissioners did not believe that the process provided in section 365(n) would necessarily work for all trademark licenses or generate the fair result — considering both the interests of the estate and the nondebtor licensee — in every case.

The Commissioners recognized, however, the uncertainty surrounding the treatment of trademark licenses in chapter 11 cases. They discussed how these licenses, to the extent they are deemed executory contracts under the Bankruptcy Code, would be treated under the recommended principles for rejection of executory contracts and leases.[468] For example, the rejection of the trademark license would constitute a breach by the debtor. It would not terminate the license or eviscerate the nondebtor licensee's rights under the license. The rejection likely would require, however, the nondebtor licensee to turn over the right to use the trademark and any associated goodwill to the estate. Moreover, the nondebtor licensee would not be able to require performance by the debtor in possession or seek equitable or injunctive relief.

The Commission considered whether section 365(n) could be modified to accommodate the unique attributes of trademark licenses and the related concerns of both the debtor licensor and the nondebtor licensee. The Commissioners discussed the advantages and disadvantages of including trademarks within the definition of intellectual property under the Bankruptcy Code. Some Commissioners believed that such inclusion was problematic because of the goodwill associated with the marks and the frequent need of trademark licensees to have access to the related products or goods, or components thereof, to utilize the marks legitimately under the license. Moreover, these Commissioners raised concerns about a debtor licensor's need to monitor quality control of the use of any marks by a licensee. Other Commissioners believed that the statute could incorporate appropriate protections and limitations to protect debtor licensors and mitigate the valid concerns regarding goodwill and ongoing compliance with the license by the licensee. The Commissioners expressed concern about the ongoing ambiguity surrounding trademarks in bankruptcy, and the related costs imposed on a debtor in possession and the estate, as well as the potential harm to the nondebtor licensee's business.

After considering the alternatives and the 2014 Innovation Act proposed in Congress,[469] the Commission determined that trademark licenses should be included in the definition of intellectual property licenses under the Bankruptcy Code. In reaching this conclusion, the Commission agreed that section 365(n) should be amended to

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[468] *See* Section V.A.3, *Rejection of Executory Contracts and Unexpired Leases*.

[469] *See* Innovation Act of 2013, H.R. 3309, 113th Cong. § 6(d) (1st Sess. 2013), *available at* https://www.congress.gov/113/bills/ hr3309/BILLS-113hr3309rfs.pdf.

address certain unique aspects of trademark licenses, including a provision that would allow a debtor in possession to monitor quality control, but otherwise not impose obligations on the debtor in possession if the license is rejected. The Commission also agreed that section 365(n) needs to expressly require a nondebtor licensee electing to retain its rights under the trademark license to comply in all respects with the license and any related agreements, including with respect to (i) the products, materials, and processes permitted or required to be used in connection with the licensed marks; and (ii) any of its obligations to maintain the sourcing and quality of the products or services offered under or in connection with the licensed marks.

6. Real Property Leases

Recommended Principles:

- The trustee's time to assume or reject unexpired nonresidential real property leases under section 365(d)(4) of the Bankruptcy Code should be extended from 210 days to one year after the petition date or date of the order for relief, whichever is later, in the interest of enhancing prospects for reorganization.
- The calculation of post-petition rent under a real property lease should be calculated under the accrual method, allowing the trustee to treat rent accrued prior to the petition date as a pre-petition claim and rent accrued on and after the petition date as a post-petition obligation. The trustee should be required to pay any such post-petition rent obligation on or before 30 days after the petition date or date of the order for relief, whichever is later. The trustee should pay all subsequent rent obligations accruing post-petition but prior to any rejection of the lease on a timely basis in accordance with the terms of the lease.
- A landlord's claim for unperformed obligations under section 365(d)(3) should apply only to monetary obligations. Such claim for unperformed monetary obligations should not receive superpriority treatment, but should instead constitute an administrative claim under section 503(b)(1) that is payable under section 507(a)(2).
- The meaning of the term "rent" under section 502(b)(6) should not be based on whether an obligation is labeled as "rent" under the lease. Rather, the Bankruptcy Code should define "rent" as any recurring monetary obligations of the debtor under the lease.
- The calculation of rejection damages for real property leases under section 502(b)(6) should be clarified as follows:

> *The claim of a lessor for damages resulting from the termination of a lease of real property shall not exceed:*
> *(i) The greater of (A) the rent reserved for one year under the lease following the termination date and (B) the alternative rent calculation; plus;*

(ii) Any unpaid rent due under the lease on the termination date.

For purposes of this section:

*The "**alternative rent calculation**" is the rent reserved for the shorter of the following two periods: (a) 15 percent of the remaining term of the lease following the termination date and (b) three years under the lease following the termination date.*

*The "**termination date**" is the earlier of the petition date and the date on which the lessor repossessed, or the lessee surrendered, the leased property.*

In calculating the rent due or reserved under the lease, such calculation should be done without acceleration.

- A landlord should be required to make reasonable efforts to mitigate damages in the event that the trustee rejects the lease under section 365, regardless of whether mitigation is required by applicable nonbankruptcy law. Any mitigation or cover received by, or security deposit held by, the landlord should reduce the landlord's pre-petition claim for purposes of calculating the section 502(b)(6) claim. A landlord's obligation to mitigate damages should continue through the claims objection deadline or the date of the order allowing the claim, whichever is earlier.
- A landlord's claims for the debtor's acts and omissions resulting in damage to the real property, other than those claims relating to the rejection of the lease or for rent under the lease, should not be subject to section 502(b)(6). The landlord should be permitted to assert any such claim as a pre-petition claim against the estate, subject to the trustee's or a party in interest's right to object and the general claims allowance process.

a. Real Property Leases: Background

Many chapter 11 debtors have one or more unexpired leases of nonresidential real property as of the petition date. These leases may be for the debtor's headquarters, stores, warehouses, or factories. They may be necessary to the debtor in possession's[470] reorganization efforts or otherwise represent valuable assets that the debtor in possession can use to maximize the value of the estate. Alternatively, they may be above-market leases or used in a part of the business being closed or downsized through the reorganization. In either scenario, a debtor in possession's ability to assume, assign,

[470] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

or reject unexpired leases of nonresidential real property is important to the resolution of its case.

The Bankruptcy Code includes several provisions that specifically address the rights and obligations of the debtor in possession and the nondebtor landlord under unexpired leases of nonresidential real property leases. For example, section 365(d)(3) requires the debtor in possession to timely perform obligations "arising from and after the order for relief under any unexpired lease of nonresidential real property, until such lease is assumed or rejected."[471] In addition, section 365(d)(4) requires the debtor in possession to assume or reject any nonresidential real property lease within 120 days after the petition date, with one 90-day extension of that deadline for cause.[472] The debtor in possession generally is given until plan confirmation to assume or reject executory contracts and other kinds of leases.[473]

Commentators and practitioners have raised issues concerning several of these provisions. Many commentators have criticized the shortened deadline for the debtor in possession to assume, assign, or reject a nonresidential real property lease under section 365(d)(4) of the Bankruptcy Code.[474] Prior to the BAPCPA Amendments, a debtor in possession had an initial 60 days to review its unexpired nonresidential leases, but it could obtain one or more extensions of this deadline for cause and with court approval.[475] Some commentators and landlords believed that courts were granting debtors in possession very lengthy extensions of the section 365(d)(4) deadline on a routine basis.[476] They believed that these open-ended extensions significantly impaired the landlords' rights under the leases and nonbankruptcy law, as well as their ability to identify substitute lessees and negotiate substitute leases in a timely manner.[477]

As a result of the BAPCPA Amendments, section 365 provides a debtor in possession with 210 days following the petition date to decide whether it will assume or reject each of its nonresidential real property leases, unless the applicable landlord consents to an extension of this deadline. Some commentators suggested, immediately following the BAPCPA Amendments, that this single change to the Bankruptcy Code would discourage large retail chains from filing chapter 11 petitions.[478] Large retail chains, in particular, frequently have hundreds of unexpired nonresidential real property leases as of the petition date, and the prospect of reviewing and making prudent

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[471] 11 U.S.C. § 365(d)(3).

[472] *Id.* § 365(d)(4).

[473] *Id.* § 365(d)(2).

[474] *Id.* § 365(d)(4).

[475] *Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?, Hearing before the H. Subcomm. on Commercial and Administrative Law*, 111th Cong. 96 (2009) (statement of Professor Jack F. Williams, Robert M. Zinman ABI Resident Scholar (2008–09)) [hereinafter Williams Statement].

[476] *See, e.g., Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (June 4, 2013) (discussion prior law), *available at* Commission website, *supra* note 55. *See generally Transcript, NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, *available at* Commission website, *supra* note 55.

[477] "The deadline was originally enacted to address problems caused by extended vacancies or partial operation by a debtor of tenant space located in shopping centers which reduced customer traffic to other nondebtor tenants due to delays in debtors deciding whether to assume or reject real property leases." *In re* FPSDA I, LLC, 450 B.R. 392, 399 (Bankr. E.D.N.Y. 2011).

[478] *See, e.g.*, Williams Statement, *supra* note 475, at 97 ("Professor Ken Klee suggests one other possible outcome — retail debtors with a significant number of leases will simply refuse to file voluntary petitions during slower periods and will instead wait to be forced into involuntary cases.") (citations omitted).

assumption or rejection decisions for each location within 210 days of the petition date, according to these commentators, would likely be too daunting and thus discourage filings in the first place.[479] Empirical and anecdotal evidence since 2005 suggests that this change in a debtor in possession's time to assume or assign nonresidential real property leases is at least a contributing factor to both the decline in retail filings and the results that were achieved in certain retail debtor cases since 2005.[480]

Courts also take different approaches to calculating the timely payments a debtor in possession is obligated to make under its nonresidential real property leases pursuant to section 365(d)(3). Some courts determine the pre-petition or post-petition status of rent amounts owed by a debtor in possession using a billing approach based on the landlord's invoice date.[481] Other courts take an accrual approach and allocate the outstanding amounts between the pre-petition and post-petition periods accordingly.[482]

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[479] *See, e.g., id.* at 96–97; *Written Statement of John Collen, Partner, Tressler LLP: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 26, 2012) (stating that 210 days may not be sufficient for a debtor to make an informed decision), *available at* Commission website, *supra* note 55; *Written Statement of Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 (Nov. 15, 2012) (stating that the 210-day period to assume or reject a nonresidential lease is too short, discourages reorganization, and impairs secured creditor recoveries), *available at* Commission website, *supra* note 55.

[480] *See* Kenneth Ayotte, *An Empirical Investigation of Leases and Executory Contracts*, (paper presented at 2014 symposium) (draft on file with Commission) (finding that BAPCPA is "associated with a significantly lower probability of reorganization for the most lease-intensive firms"). *See also Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (Nov. 3, 2012) (arguing that the 210-day period is insufficient, particularly for retail debtors), *available at* Commission website, *supra* note 55; *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (testifying that the primary problem in retail reorganizations is lender control and stating that "[l]enders are sometimes willing to provide *only* enough financing to position a debtor for liquidation in the first few months of the case, and then impose restrictive covenants in post-petition financing agreements that either direct an immediate liquidation of the company, or include covenants or borrowing reserve rights that effectively allow the lender to 'pull the plug' on the retailer only a few months into the case"), *available at* Commission website, *supra* note 55; *Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (explaining the tension in the timing regarding the desire of the secured creditor to liquidate the debtors' assets and the ability of the debtor to effectively conduct going-out-of-business ("***GOB***") sales at its retail locations; given the 210-day limit set by BAPCPA and given the fact that a GOB sale takes at least 120 days in most cases, the debtor has 30 to 90 days to sell its company; landlords are also unwilling to negotiate, which increases the prevalence of quick liquidations in retail cases), *available at* Commission website, *supra* note 55; *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013) (stating that the 210-day limit to assume or reject nonresidential leases puts retailers in a timing pinch; because GOB sales generally take at least 120 days and must take place in their retail locations, the 210-day limit to assume or reject leases puts inordinate pressure on debtors to decide within 90 to 120 days after filing to either quickly file a chapter 11 plans while complying with all their lenders' requirements, or to liquidate; also stating that the 210-day deadline to assume or reject nonresidential leases means it is nearly impossible for a middle-market retail company to do anything but conduct a GOB sale), *available at* Commission website, *supra* note 55.

[481] *See* Centerpoint Props. v. Montgomery Ward Holding Corp. (*In re* Montgomery Ward Holding Corp.), 268 F.3d 205, 209–10 (3d Cir. 2001); *Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–8 (June 4, 2013) (describing how this "stub rent" problem means that landlords are, perhaps unfairly, losing money because of the timing of debtors' bankruptcy filings), *available at* Commission website, *supra* note 55.

[482] *See In re* Stone Barn Manhattan LLC, 398 B.R. 359, 362–65 (Bankr. S.D.N.Y. 2008) (using the accrual method but providing historical overview and case cites of the accrual versus billing date approach).

Courts also differ on the priority accorded to any unpaid post-petition amounts due under section 365(d)(3).[483]

Similarly, if a debtor in possession rejects a nonresidential real property lease, the landlord's claim for rejection damages is generally subject to the cap provided by section 502(b)(6) of the Bankruptcy Code. Section 502(b)(6) generally "limits a landlord's 'damages resulting from the termination of a lease of real property' to an amount equal to the rent the debtor-tenant would have paid for a period of one to three years, depending on the remaining term of the lease."[484] The calculation of the section 502(b)(6) cap, as well as what constitutes rent or otherwise should be included in the calculation, often produces litigation and uncertain results in chapter 11 cases.[485] Notably, courts are split regarding the application of the section 502(b)(6) cap to nontermination damages relating to the lease, which could constitute millions of dollars and significantly impact unsecured creditors' pro rata share of estate assets.[486]

b. Real Property Leases: Recommendations and Findings

The Commission reviewed several issues relating to nonresidential real property leases. Several Commissioners voiced strong concerns regarding the shortened deadline for a debtor in possession to assume or reject nonresidential real property leases under section 365(d)(4). The Commissioners suggested that the current deadline is preventing potential debtors from using chapter 11, at least on a voluntary and timely basis, and is making it more difficult for retail chains to reorganize their businesses.[487]

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[483] *Compare In re* Oreck Corp., 506 B.R. 500 (Bankr. M.D. Tenn. 2014) (holding that debtor's obligation to pay occurred prepetition was not subject to priority treatment), *with In re* Leather Factory Inc., 475 B.R. 710 (Bankr. C.D. Cal. 2012) (holding that "stub rent" owed to landlord was a priority administrative claim).

[484] 11 U.S.C. § 502(b)(6); Michael St. Patrick Baxter, *The Application of § 502(b)(6) to Nontermination Lease Damages: To Cap or Not to Cap?*, 83 Am. Bankr. L.J. 111 (2009).

[485] *See, e.g., In re* Heller Ehrman LLP, 2011 WL 635224 (N.D. Cal. Feb. 11, 2011) (discussing challenges in determining remaining term of lease); *In re* Titus & McConomy, LLP, 375 B.R. 165 (Bankr. W.D. Pa. 2007) (holding that, because one year's rent was greater than 15 percent of remaining term of lease following petition date, section 502(b)(6)(A) determined amount of cap was equal one year's rent).

[486] Baxter, *supra* note 484, at 113–14.

[487] *See, e.g.*, Sharon Bonelli, Isabel Hu, Gregory Fodell, *U.S. Retail Case Studies in Bankruptcy Enterprise Value and Creditor Recoveries*, Fitch Ratings, Apr. 16, 2013; *Written Statement of Lawrence Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 4, 2013) ("The deadline established under BAPCPA for a debtor to assume or reject unexpired leases of nonresidential property has had a substantial and unfortunate affect on retailers' ability to meet liquidity needs and obtain extended post-petition financing — the lynchpin to any successful retail reorganization."), *available at* Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (noting that the maximum time limit to assume or reject nonresidential real property leases should be amended, as it takes time to thoroughly assess whether a lease should be maintained for the value of reorganization efforts), *available at* Commission website, *supra* note 55; *Oral Testimony of Grant Stein: AIRA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 7, 2013) (AIRA Transcript) (noting that the court should allow more time for the assumption or rejection if it is appropriate in the circumstances), *available at* Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 8–9 (Nov. 15, 2012) ("Debtors and their secured and unsecured creditors must make decisions about whether to retain leases in a period of time that is often unrealistically short. As a result, businesses that might have been reorganized or sold as going concerns to new owners are liquidated instead. Because they know that debtors with significant leases will have difficulty reorganizing, lenders are less willing to support reorganizations with DIP financing. They do not want to begin lending money to a chapter 11 debtor only to have to choose, 7 months later, between agreeing to an unfavorable deal with a landlord that has such significant leverage and liquidating the debtor,

The Commissioners also noted that the 210-day deadline is misleading because post-petition lenders have been requiring debtors in possession to make their decisions about nonresidential real property leases as early as 120 to 150 days after the petition date to permit these lenders to preserve their security interests in the debtors' leaseholds before the expiration of the section 365(d)(4) deadline.[488]

Other Commissioners, while acknowledging these troubling facts, emphasized the need to balance the concerns raised by landlords before the BAPCPA Amendments when courts were granting very lengthy extensions.[489] They encouraged the Commission to find a compromise that would provide more flexibility to debtors in possession to secure financing and to review their unexpired leases within a reasonable time frame without eliminating the certainty that section 365(d)(3) currently provides to landlords.[490] After considering and debating different approaches that ranged from reversion to the pre-BAPCPA standard to maintenance of the status quo, the

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possibly at a loss to the lender. So they simply refuse to provide DIP financing in the first place, forcing debtors to liquidate before they have had an opportunity to make operational changes, regardless of the potential for reorganization. In addition, going concern asset sales (a frequent form of 'reorganization' without a plan) become more difficult and less advantageous to creditors and owners because buyers have insufficient time to assess the value of an enterprise with important leases. Uncertainty about value always results in lower prices and therefore lower payments to creditors. Worse, such uncertainty can render going concern sales so difficult that they are not even pursued, again resulting in otherwise avoidable liquidations."), *available at* Commission website, *supra* note 55.

[488] *See Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–5 (June 4, 2013) (stating that the deadline should be expanded to allow time for a debtor to secure post-petition financing and conduct a going-out-of-business sale and stating that prepetition lenders often demand provisions that result in a liquidation sale before the expiration of the 210-day period), *available at* Commission website, *supra* note 55. *But see Written Statement of David L. Pollack, Partner, Ballard Spahr LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (June 4, 2013) (stating that neither section 365(d)(4) time limits nor commercial landlords are causing retailers to fail and providing specific case examples to support assertion; also noting that retailers are failing because of other reasons, such as DIP financing conditions and reluctance of trade creditors to continue to extend credit), *available at* Commission website, *supra* note 55. *See also* Ayotte, A*n Empirical Investigation of Leases and Executory Contracts*, *supra* note 480 (finding that the seven-month limit to assume or reject a commercial lease instituted by BAPCPA (absent an extension from the landlord) "accelerated real estate lease disposition decisions"). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[489] *See, e.g., Written Statement of Elizabeth Holland on behalf of the International Council of Shopping Centers: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (June 4, 2013) ("The 2005 amendments that created more certainty for shopping center owners now provide an important 'firewall' which prevents the failure of one retailer from cascading to other businesses. Under the prior law, lingering uncertainty caused neighboring stores to suffer from reduced traffic and sales while potential new tenants were reluctant to rent space in a shopping center with an uncertain future. For property owners, the contraction in credit has been even more problematic; a bankrupt tenant can cause a shopping center to default on a mortgage with no ability to cure the default. Such defaults include covenants to maintain minimum occupancy and debt service coverage."), *available at* Commission website, *supra* note 55.

[490] *Id.* at 2 (June 4, 2013) (stating that the time limits for debtors to assume or reject a nonresidential lease introduced by BAPCPA have "provid[ed] shopping center owners with reasonable certainty as to the disposition of leases, have prevented deterioration in shopping center properties and helped owners have access to credit to finance construction and renovation"), *available at* Commission website, *supra* note 55; *Oral Testimony of the Honorable Melanie Cyganowski (Ret.), former U.S. Chief Bankruptcy Judge, E.D.N.Y.: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 19 (Nov. 15, 2012) (CFA Transcript) (stating that it would be beneficial to the court and will encourage more secured lenders to support middle-market borrowers if the BAPCPA Amendments relating to lease and plan deadlines were repealed, or at a minimum amended to provide judicial discretion to be exercised to modify the deadlines as appropriate), *available at* Commission website, *supra* note 55.

Commission voted to provide the debtor in possession one year from the petition date to make its assumption, assignment, or rejection decision with respect to nonresidential real property leases.

The Commission also discussed the split in the courts regarding the method — i.e., the billing approach or the accrual approach — that should be used to determine whether certain rent owed under the lease should be deemed a pre-petition or a post-petition obligation. The Commission reviewed case law citing both approaches to determine which approach should be adopted and codified, and focused its efforts on creating, first and foremost, a uniform standard. Ultimately, the Commission decided that the accrual method, which allocates rent between the pre-petition and post-petition periods based on the date of filing, was a fair method and most closely aligned with the purpose of section 365(d)(3).

The Commission further considered the scope of a debtor in possession's obligations under section 365(d)(3). Some of the Commissioners commented on the ambiguity in the case law regarding which obligations were captured by section 365(d)(3) and how those obligations, if deferred or unpaid, should be treated. With respect to which obligations should be deemed "rent," the Commission reviewed the language of section 365(d)(3), which references section 365(b)(2), but not historical nonmonetary obligations in section 365(b)(1). The Commissioners debated whether this omission in the statute suggests that a debtor in possession should be required to perform all nonmonetary obligations on and after the petition date as provided in section 365(d)(3). Several Commissioners, however, highlighted that such a reading of section 365(d)(3) may be inconsistent with the Commission's recommended policies and approaches. Specifically, these Commissioners asserted that a debtor in possession (i) should not be required to perform under any executory contracts or unexpired leases, except to pay for post-petition goods and services (including rent), pending assumption or rejection; and (ii) should not be required to cure nonmonetary defaults that occurred prior to assumption. In light of these recommendations and the Commission's proposal for a relatively modest extension of the section 365(d)(4) deadline, the Commission decided to recommend limiting section 365(d)(3) to monetary obligations under the leases and to provide ordinary administrative priority (not superpriority) to any such unpaid or deferred obligations under section 365(d)(3).

In addition, the Commissioners evaluated the inconsistent application of section 502(b)(6) to calculate the maximum amount of a landlord's rejection damages. The Commission agreed with courts that have held that whether a given obligation is labeled as "rent" under a lease should not determine whether such obligation is subject to the section 502(b)(6) cap. The Commissioners identified obligations that have been commonly considered as "rent" (e.g., monthly payments for occupying the property (including base rent, additional rent, percentage rent), common area maintenance charges, taxes, and insurance) and determined that the definition of "rent" suggested by the advisory committee — "any recurring monetary obligations of the debtor under the lease" — adequately captured these obligations. The Commissioners also analyzed the varying interpretations and applications of the formula for calculating the cap on rejection damages under section 502(b)(6). The Commission agreed that many courts have confused or misapplied the formula and that, simply stated, the cap should be the

rent reserved under the lease for the greater of (i) one year and (ii) the shorter of 15 percent of the remaining term and three years, plus unpaid rents. Accordingly, the Commission voted to recommend clarifying the calculation formula.

Finally, the Commission considered the treatment of nontermination damages that a landlord may assert against the estate. These claims typically arise out of the debtor's use or occupancy of the property and are not related to the debtor's rejection of the lease. Notably, section 502(b)(6) applies to, and limits, "the claim of a lessor for damages resulting from the termination of a lease of real property." Accordingly, the Commission agreed that a landlord should be able to file a pre-petition claim against the estate, to the extent that the landlord can establish a legal basis and adequate factual support for such claim, for damages not resulting from the rejection of the lease. Such claim would be subject to the claims objection and allowance process under the Bankruptcy Code.

B. Use, Sale, or Lease of Property of the Estate

Section 363 of the Bankruptcy Code addresses the debtor in possession's use, sale, or lease of property during the chapter 11 case. Section 363(c) permits the debtor in possession to engage in certain of these transactions in the ordinary course of business without court approval.[491] If the debtor in possession wants to use, sell, or lease property outside the ordinary course of business, section 363(b) requires, among other things, notice and a hearing, and prior court approval.[492] Section 363(f), in turn, allows the debtor in possession to sell property free and clear of any interest in such property under certain circumstances.[493]

1. General Provisions for Non-Ordinary Course Transactions

Recommended Principles:

- Except in the context of a sale of all or substantially all of a debtor's assets (i.e., a section 363x sale), the court should approve the use, sale, or lease of a debtor's assets outside the ordinary course of business only if the court finds by a preponderance of the evidence that the trustee exercised reasonable business judgment in connection with the proposed transaction. This approach often is referred to as an "enhanced" or "intermediate" level of review that considers not only the process adopted by the board of directors (or similar governing body) to approve the transaction but also the reasonableness of the decision itself.
- Only the trustee should be able to propose the use, sale, or lease of a debtor's assets outside the ordinary course of business. Accordingly, no change to existing law is suggested on this point.

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[491] 11 U.S.C. § 363(c)(1). Nevertheless, if a debtor is selling, leasing, or using assets that constitute "cash collateral," then the debtor must obtain the secured creditor's consent or court approval. *Id.* § 363(c)(2).

[492] *Id.* § 363(b).

[493] *Id.* § 363(f).

- A secured creditor's collateral should not be subject to a mandatory surcharge in favor of the estate but the court should retain the authority to make appropriate allocations of value to the estate as may be warranted under the circumstances pursuant to sections 506(c) and 552(b) of the Bankruptcy Code, as clarified by the related principles. See Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.4, *Section 552(b) and Equities of the Case*.
- For the standard of review governing section 363x sales, see Section VI.B, *Approval of Section 363x Sales*.

a. General Provisions for Non-Ordinary Course Transactions: Background

In general, section 363(b) of the Bankruptcy Code provides that the debtor in possession,[494] "after notice and a hearing, may use, sell, or lease, outside the ordinary course of business, property of the estate."[495] The debtor in possession can use, sell, or lease a single asset, multiple assets, a division, or more. A sale of all or substantially all of the debtor's assets is addressed separately in these principles and is subject to a different standard of review and additional procedures.[496]

Under section 363(b), a debtor in possession generally must provide at least 21 days' notice of a motion to approve a proposed use, sale, or lease of property.[497] In general, any party in interest may object to the motion. At the hearing, the debtor in possession bears the burden of proof on the motion and generally must satisfy that burden by a preponderance of the evidence.[498] Courts generally evaluate section 363(b) motions under a business judgment standard. More precisely, courts often state they will approve the motion only if it represents an exercise of the debtor in possession's sound business judgment.[499] But, courts are not always clear or consistent in explaining the factors they consider under this business judgment standard.

b. General Provisions for Non-Ordinary Course Transactions: Recommendations and Findings

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[494] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[495] *Id.* § 363(b).

[496] *See* Section VI.B, *Approval of Section 363x Sales*.

[497] Fed. R. Bankr. P. 2002.

[498] *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983) ("[A] debtor applying under § 363(b) carries the burden of demonstrating that a use, sale or lease out of the ordinary course of business will aid the debtor's reorganization . . . ."); *In re* Telesphere Commc'ns, Inc., 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("[T]he proponent of the sale bears the ultimate burden of persuasion . . . ."); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 675 (Bankr. S.D.N.Y. 1989) ("[Debtor] clearly bears the burden of demonstrating that a sale of property out of the ordinary course of business under § 363(b) of the [Bankruptcy] Code will aid [debtor's] reorganization and is supported by a good business justification.").

[499] *In re* On-Site Sourcing, Inc., 412 B.R. 817, 822 (Bankr. E.D. Va. 2009) ("'A § 363(b) sale is generally viewed as quicker. Only a motion and a hearing are required, and most courts apply a 'business judgment test' to determine whether to approve the sale.'" (quoting *In re* Gulf Coast Oil Corp., 404 B.R. 407, 415 (Bankr. S.D. Tex. 2009)).

The Commissioners engaged in a detailed review of the various kinds of non-ordinary course transactions pursued by debtors in possession under section 363(b). Debtors in possession have used this provision to enter into long-term equipment lease arrangements or new real property leases that require a substantial outlay of resources; to hire a service provider who is not a professional under section 327; and even to compromise and settle a cause of action.[500] The most common use of section 363(b), however, is to sell the debtor's assets. In each of these instances, the estate is potentially losing something — i.e., cash in the lease, hiring, and settlement scenarios, and assets in the sale context. The Commissioners thus emphasized the important roles of process and review in the approval of these transactions.

The Commissioners examined the various standards of review applicable to similar transactions under state law. In many cases, directors' decisions are protected under state law by the business judgment rule, which presumes that "'in making a business decision the directors of a corporation acted on an informed basis, in good faith, and in the honest belief that the action taken was in the best interests of the company.'"[501] Courts have articulated slightly different standards for reviewing proposed transactions under either the business judgment rule or some enhanced form of scrutiny. These variations typically depend on the kind of transaction at issue and the parties involved in the transaction.

For example, some courts undertake a very deferential review of a company's business judgment, focusing largely on the process followed by the board of directors to evaluate and approve the proposed transaction; these courts then defer to the company's articulated business justifications.[502] This type of deferential judicial review often is explained by the notion that business decisions are better made in the boardroom than the courtroom.[503] Other courts scrutinize proposed transactions more closely, reviewing not only the process implemented by the company, but also the reasonableness of the

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[500] *In re* Schipper, 933 F.2d 513, 515 (7th Cir. 1991) (holding that debtor had "sound business reasons for making the sale"); *In re* Cont'l Air Lines, Inc., 780 F.2d 1223, 1226 (5th Cir. 1986) ("[F]or the debtor-in-possession or trustee to satisfy its fiduciary duty to the debtor, creditors and equity holders, there must be some articulated business justification for using, selling, or leasing the property outside the ordinary course of business."); *In re* Ionosphere Clubs, Inc., 100 B.R. 670, 680 (Bankr. S.D.N.Y. 1989) (finding that debtor "articulated sound business reasons for, and is appropriately exercising business judgment with respect to, its decision to sell [certain assets]"); *In re* Baldwin United Corp., 43 B.R. 888, 897 (Bankr. S.D. Ohio 1984) (finding that debtors "met their burden of demonstrating that the disposition will aid their reorganization, and is supported by sound business reasons").

[501] *In re* Walt Disney Co. Derivative Litig., 906 A.2d 27, 52 (Del. 2006) (quoting Aronson v. Lewis, 473 A.2d 805, 812 (Del. 1984)).

[502] Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 n.17 (Del. 1994); *In re* Walt Disney Co. Derivative Litig., 906 2d 27, 74 (Del. 2006) (quoting Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971)).

[503] *See, e.g.*, Brehm v. Eisner, 746 A.2d 244, 266 (Del. 2000) (holding that the Court of Chancery correctly deferred to the business decision of the board because "[t]o rule otherwise would invite courts to become super-directors, measuring matters of degree in business decisionmaking and executive compensation. Such a rule would run counter to the foundation of our jurisprudence"). *See also* King v. Terwilliger, 2013 WL 708495, at *7 (S.D. Tex. Feb. 26, 2013) (finding that compensation issues are business questions "far better suited to the boardroom than the courtroom"); *In re* Curlew Valley Assocs., 14 B.R. 506, 511 (Bankr. D. Utah 1981) ("[D]isagreements over business policy are not amenable to judicial resolution. The courtroom is not a boardroom. The judge is not a business consultant. While a court may pass upon the legal effect of a business decision, (for example, whether it violates the antitrust laws), this involves a process and the application of criteria fundamentally different from those which produce the decision in the first instance. In short, the decision calls for business not legal judgment.").

board of directors' business judgment under the circumstances of the case.[504] This latter review often is referred to as an "enhanced" or "intermediate" business judgment standard. In certain limited circumstances, courts apply heightened scrutiny under which the court exercises its own business judgment and determines if the decision is in the best interests of the company.[505] Finally, if the proposed transaction involves potential self-dealing, conflicts of interests, or insiders, the court may require the company to establish the entire fairness of the transaction.[506]

After much deliberation, the Commission determined that an enhanced business judgment standard was appropriate for evaluating general asset sales and other transactions under section 363(b). The court should approve the sale if it represents a reasonable process and a reasonable exercise of the debtor in possession's business judgment. Moreover, the Commission agreed that only the debtor in possession should be permitted to request the use, sale, or lease of property of the estate, which currently is the structure of section 363.

The Commissioners discussed situations in which the debtor in possession sells assets, and unsecured creditors seek recoveries from that sale, despite the fact that such assets are fully encumbered by a secured creditor's lien. The Commissioners recognized that this situation has occurred more frequently in the most recent economic cycle. Debtors have filed chapter 11 cases with substantially all of their assets fully encumbered by pre-petition liens, leaving little value for the debtors' other creditors, at least at the outset of the case. The Commissioners noted that, in some cases, secured

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[504] *In re* Netsmart Techs., Inc. Stockholders Litig., 924 A.2d 171, 192 (Del. Ch. 2007). *See also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 45 (Del. 1994) ("[C]ourt applying [the *Revlon* standard] should be deciding whether the directors made a reasonable decision, not a perfect decision. If a board selected one of several reasonable alternatives, a court should not second-guess that choice even though it might have decided otherwise or subsequent events may have cast doubt on the board's determination.").

505 *See* Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981) (indicating that judicial business judgment may be warranted in derivative litigation involving a special litigation committee in which demand was excused under applicable state law). *See also, e.g., In re* Telesphere Commc'ns, Inc., 179 B.R. 544, 552 (Bankr. N.D. Ill. 1994) ("Where an objection is made, the standard to be applied by the court in approving a disposition of assets is variously stated, but the general thrust is that the proposed sale should be in the best interests of the estate."); *In re* Am. Dev. Corp., 95 B.R. 735, 739 (Bankr. C.D. Cal. 1989) ("The proposed transaction is certainly not in the ordinary course of business and requires [the court's] approval. Debtor has the burden of proof to persuade [the court] that the proposed transaction is appropriate in light of its reorganization effort and should be approved."). Also, some courts have been less deferential with respect to break-up fees. *See, e.g., In re* Tiara Motorcoach Corp., 212 B.R. 133, 137 (Bankr. N.D. Ind. 1997) ("This court agrees with the position taken in *S.N.A.*, *America West*, and *Hupp*. A sale pursuant to § 363 of the Bankruptcy Code is outside the ordinary course of business, and the business judgment of the debtor should not be solely relied upon. Rather, a court should insure that revenues are maximized and that the best interests of the debtor's estate, creditors and equity holders are furthered. Therefore, 'the proposed break-up fee must be carefully scrutinized to insure that the Debtor's estate is not unduly burdened and that the relative rights of the parties in interest are protected.'") (citations omitted); *In re* Am. W. Airlines, Inc., 166 B.R. 908, 912 (Bankr. D. Ariz. 1994) ("[T]he Court must take into consideration what is in the best interests of the estate. As stated, the standard is not whether a break-up fee is within the business judgment of the debtor, but whether the transaction will 'further the diverse interests of the debtor, creditors and equity holders, alike.'") (citing *In re* Lionel Corp., 722 F.2d 1063, 1071 (2d Cir. 1983)). *But see* Official Comm. of Subordinated Bondholders v. Integrated Res. (*In re* Integrated Res., Inc.), 147 B.R. 650 (S.D.N.Y. 1992), *appeal dismissed by* 3 F.3d 49 (2d Cir. 1993) (finding that the business judgment rule applied in nonbankruptcy contexts and thus relied upon that standard in the bankruptcy context as well to determine whether the proposed breakup fee at issue was appropriate).

[506] Telxon Corp. v. Meyerson, 802 A.2d 257, 264 (Del. 2002). *See also* Paramount Commc'ns Inc. v. QVC Network Inc., 637 A.2d 34, 42 n.9 (Del. 1994) ("Where actual self-interest is present and affects a majority of the directors approving a transaction, a court will apply even more exacting scrutiny to determine whether the transaction is entirely fair to the stockholders").

lenders will agree to set aside certain amounts for administrative or unsecured claims. The Commissioners, however, did not believe that such surcharges should be mandatory in every section 363 transaction. Rather, parties should remain free to negotiate these types of set-asides based on the facts of any given case. In addition, the Commission reviewed the recommended principles relating to sections 506(c)[507] and 552(b),[508] and found that those sections, together with the new procedures proposed for section 363x sales,[509] sufficiently addressed the underlying concerns.

2. Finality of Orders

Recommended Principles:

- The court should not be permitted to reconsider a non-ordinary course transaction after the entry of an order approving the transaction or to reopen an auction unless the court finds extraordinary circumstances or material procedural impediments (such as the lack of adequate notice or an improperly conducted sale process) to the auction process that may have had a material effect on the sale results. For purposes of this principle, the potential that a new or continued auction would generate a higher value for the transaction alone does not constitute extraordinary circumstances.

a. Finality of Orders: Background

In the section 363 sale context, a debtor in possession[510] seeks to obtain the highest and best price for the assets. As explained above, a debtor in possession typically conducts an auction process to facilitate this result.[511] The auction procedures are reviewed and approved by the court and may include a marketing and diligence period and rules governing the auction itself.[512] The auction procedures also may contemplate certain bid protections for any stalking horse bidder.[513] After the auction, the debtor in

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[507] *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral*.

[508] *See* Section VI.C.4, *Section 552(b) and Equities in the Case*.

[509] *See* Section VI.B, *Approval of Section 363x Sales*.

[510] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[511] *See* Section IV.C.2, *Timing of Section 363x Sales*.

[512] One court concluded that "it was necessary to have in place bidding procedures that would provide a reasonable opportunity for the APA to be tested against the market." *In re* Tex. Rangers Baseball Partners, 431 B.R. 706, 711 (Bankr. N.D. Tex. 2010). *See also In re* Innkeepers USA Trust, 448 B.R. 131, 148 (Bankr. S.D.N.Y. 2011) (explaining that bid procedures provide "the market and the Debtors the certainty and the 'rules' that they need to complete the auction process and move on to plan confirmation").

[513] A leading bankruptcy treatise explains the rationale for deciding such bid protections in advance of the auction:

> Frequently, the issue of whether the court should approve buyer protections arises upon a motion to approve bidding procedures. The court is asked to approve, before the fact, procedures the propriety of which may be better determined after the "auction" of the property. For example, the reasonableness of a breakup or topping fee may be more difficult to evaluate in a vacuum before the sale. Whether a particular procedure chilled bidding may not be determinable until after the trustee offers the successful bid to the court for approval.

possession presents the winning bid at the auction to the court for approval under the motion to approve the sale. After the court enters the sale order, parties generally have 14 days to appeal the order or it becomes final.[514] Generally, courts are not permitted to reopen an auction or sale.[515]

Several issues can arise during the course of the sale process, including modifications to the auction procedures without notice to or approval by the court, bidders wanting to submit noncompliant bids, and even late bidders who cause the debtor in possession, the unsecured creditors' committee, or other party in interest to question whether the bid selected at the auction really is the best and highest offer for the debtor's assets. In this context, courts have granted motions to reopen an auction if it would likely result in a better offer.[516] Accordingly, courts face challenging issues and competing interests when confronted with requests to reopen the auction process or to reconsider the order approving the sale under section 363 of the Bankruptcy Code.

b. Finality of Orders: Recommendations and Findings

The closing of an auction and the entry of a sale order are key steps in the sale of the debtor's assets. They allow the debtor in possession to close the sale and move forward in the case and the successful bidder to take possession of the assets. The Commissioners discussed the importance of the value generated by section 363 sales to the estate, and the common desire to want to ensure that the sale process is extracting as much value as possible from the assets. The Commission reviewed examples in which this desire caused the debtor in possession, the unsecured creditors' committee, or a party in interest to second-guess the auction results or the sale order and to seek related relief from the court.

> However, the fees are to compensate the bidders for facilitating the auction, for example, by guaranteeing a floor on the bidding. If the court were not to approve the fee until after the auction, the leading bidder would not have the assurance necessary to commit to support the auction. Therefore, authorizing the fee only after the auction would defeat its purpose, and the court should address the issues upon a motion to approve the bid procedures."

3 *Collier on Bankruptcy* ¶ 363.02[7].

[514] Bankruptcy Rule 6004(h) provides that "[a]n order authorizing the use, sale, or lease of property other than cash collateral is stayed until the expiration of 14 days after entry of the order, unless the court orders otherwise." Fed. R. Bankr. P. 6004(h).

[515] *See* Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005), *aff 'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010). *See also In re* Gil-Bern Indus., Inc., 526 F.2d 627, 628, 629 (1st Cir. 1975) ("[I]t is an abuse of discretion for a bankruptcy court to refuse to confirm an adequate bid received in a fairly conducted sale merely because a slightly higher offer has been received after the bidding has closed."); *In re* Bigler, LP, 443 B.R. 101, 112 (Bankr. S.D. Tex. 2010) ("To reopen the bidding process to allow [a losing bidder] to make its late bid would be an abuse of this Court's discretion. Accordingly, this Court will not reopen bidding.").

[516] *In re* Foamex Int'l, Inc., No. 09-10560 (KJC) (Bankr. D. Del. May 27, 2009). *See also* Lithograph Legends, LLC v. U.S. Trustee, 2009 WL 1209469, at *3 (D. Minn. Apr. 30, 2009) ("A bankruptcy court may disapprove a proposed sale recommended by a debtor-in-possession 'if it has an awareness there is another proposal in hand which, from the estate's point of view, is better or more acceptable.'") (quoting G-K Dev. Co v. Broadmoor Place Invs., L.P. (*In re* Broadmoor Place Invs., L.P.), 994 F.2d 744, 746 (10th Cir. 1993)).

For example, in the *WestPoint Stevens*[517] chapter 11 case, the debtor in possession obtained approval of the court to conduct an auction for substantially all of the debtor's assets.[518] One of the debtor's secured creditors, Aretex LLC, along with its affiliates, emerged as the winning bidder at the auction.[519] The court approved the sale and entered a sale order permitting the consummation of the sale to Aretex for the highest and best bid.[520] But, before the sale closed, certain other lenders moved for a stay of the sale order pending appeal of certain provisions in the sale order related to lien releases, claim satisfaction, and distributions.[521] On appeal, however, the Second Circuit rejected the appeal as statutorily moot under section 363(m).[522]

The Commission also reviewed a contrary example found in the *Foamex* chapter 11 case. In that case, the debtors had selected an all-cash bid that was $5 million lower than the all-cash bid of the stalking horse because the stalking horse had conditioned its bid on the inclusion of a credit bid if the auction continued past the then-present round. The bankruptcy reopened the auction and directed the debtors in possession to accept the stalking horse bid (which included the credit bid), even though the debtors in possession had complied with the court-approved bid procedures in accepting the previous bid. The court thereafter overruled the objection by the previous winning bidder to the sale.

The Commissioners acknowledged that, in some cases, reopening the auction or reconsidering the sale order may generate additional value for the estate. They also raised concerns, however, that endorsing this type of relief may prevent robust auctions in the first instance because prospective bidders need to understand the rules of the auction and to know that, if they participate according to the rules and win, they will be able to close the sale. This type of certainty and respect for the auction rules and sale order can enhance the auction itself and prevent gamesmanship by prospective bidders.

The Commissioners also noted that courts currently have the ability to reconsider their orders under Rule 60(b) of the Federal Rules of Civil Procedure, which provides that the court may relieve a party from a final order if presented with "newly discovered evidence which by due diligence could not have been discovered in time to move for a new trial" and due to "fraud . . . misrepresentation, or other misconduct of an adverse party." The Commissioners reviewed cases in which courts have reconsidered (or refused to reconsider) sale orders.[523] They acknowledged that a motion to reconsider a

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[517] Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30 (S.D.N.Y. 2005), *aff 'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010).

[518] *Id.* at 35.

[519] *Id.* at 36.

[520] Contrarian Funds LLC v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231, 242 (2d Cir. 2010) (noting that bankruptcy court entered order confirming that "the winning bid presented 'the highest and best bid at the Auction'") (citations omitted).

[521] Contrarian Funds, LLC v. Westpoint Stevens, Inc. (*In re* Westpoint Stevens, Inc.), 333 B.R. 30, 37 (S.D.N.Y. 2005), *aff 'd in part and rev'd in part sub nom.* Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231 (2d Cir. 2010).

[522] Contrarian Funds v. Aretex LLC (*In re* WestPoint Stevens, Inc.), 600 F.3d 231, 247 (2d Cir. 2010).

[523] For examples of courts considering the finality issue and refusing to reopen auction, see *In re* Bigler, LP, 443 B.R. 101 (Bankr. S.D. Tex. 2010); *In re* Extended Stay Inc., No. 09-13764 (JMP) (Bankr. S.D.N.Y. June 17, 2010) [Docket No. 1102] (transcript of record); *In re* Finlay Enters., Inc., No. 09-14873 (Bankr. S.D.N.Y. Nov. 12, 2009)

section 363 sale order can be clouded by the prospect of more value for the estate. Nevertheless, the Commissioners believed that more value alone as ground for reopening an auction or setting aside a sale order was too low of a barrier, did not comply with Rule 60(b), and would introduce too much uncertainty into the sale process.

Consequently, the Commission voted to recommend codifying the standards governing requests to reopen an auction or to reconsider and set aside a sale order. Specifically, it determined that such relief should be warranted only in instances when the evidence presented at the hearing demonstrates procedural impediments in the auction or sale process or extraordinary circumstances.

3. Transactions Free and Clear of Interests

Recommended Principles:

- In general, the trustee should be able to sell a debtor's assets free and clear of all interests in a debtor's assets, including liens and encumbrances, to the extent permitted by the U.S. Constitution and the guidelines set forth in these principles. In addition, the trustee should be able to sell a debtor's assets free and clear of all claims related to a debtor's assets in the context of a sale of all or substantially all of a debtor's assets under section 363x (or a transaction involving less than substantially all of the debtor's assets if the court determines that the trustee has otherwise complied with the requirements of section 363x).
- A trustee should be able to sell assets free and clear of interests if applicable nonbankruptcy law would permit the owner of such assets to sell them free and clear of such interests. The foreclosure rights of a creditor or other third party should not be determinative in this context. Bankruptcy Code section 363(f)(1) and (5) should be amended accordingly.
- A trustee should be able to sell assets free and clear of interests without the consent of any lienholder and regardless of whether the assets generate value in excess of the aggregate value of the liens in the assets, provided that the liens attach to the proceeds of the sale or the lienholder receives another appropriate form of adequate protection of the lien. Section 363(f)(3) should be amended accordingly.
- In the context of a section 363x sale, a trustee should be able to sell assets free and clear of any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales by these principles.
- The court should not approve a sale of a debtor's assets free and clear of the following kinds of interests: (i) easements, covenants, use restrictions, usufructs, or equitable servitudes that are deemed to "run with the land" under applicable nonbankruptcy law; (ii) environmental obligations that are deemed to "run with the land" under applicable nonbankruptcy law; (iii) successorship liability for purposes of federal labor law; and (iv) partial, competing, or

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[Docket No. 378] (transcript of record). *But see* Corporated Assets, Inc. v. Paloian, 368 F.3d 761 (7th Cir. 2004) (auction reopened due to improper procedures).

disputed ownership interests, except to the extent specified in section 363(h) or (i).

- The sale of a debtor's assets free and clear of executory contracts and unexpired leases should be governed by section 365 or, for collective bargaining agreements, section 1113. Accordingly, the trustee should be permitted to sell the debtor's assets free and clear of executory contracts and unexpired leases only to the extent such contracts and leases are rejected in accordance with section 365 or section 1113, as applicable, and the trustee is permitted by section 365 to recover the property free and clear of the nondebtor counterparty's rights to use or possess such property.
- The court's approval of a sale free and clear of interests or claims under section 363(f) should continue to be considered part of the court's approval of the overall transaction under section 363(b) or (c). Accordingly, no change to existing law is suggested on this point.
- To the extent permitted by these principles for other claims, the trustee should be able to sell a debtor's assets free and clear of any monetary claims by the federal government or a state government against the debtor or the estate, provided that such monetary claims constitute "claims" under section 101(5) under current law. The trustee should not be able to sell a debtor's assets free and clear of any enforcement rights of such government to the extent that such rights are within such government's police or regulatory powers and could be enforced against the debtor or the estate under section 362(b)(4), or to the extent that the state or federal government incurs costs post-sale in the exercise of its police or regulatory powers.

a. Transactions Free and Clear of Interests: Background

In many chapter 11 cases, some or all of the debtor's property is encumbered or subject to the liens, interests, and claims of various stakeholders. The holders of these liens, interests, and claims may have rights under nonbankruptcy law or pre-petition agreements that make the transfer of the debtor's assets difficult or less attractive to prospective lessees and purchasers. These liens, interests, and claims may include mortgages, security interests, easements, or successor liability claims.

Under section 363(f), a debtor in possession[524] may sell its assets under section 363(b) or (c) "free and clear of any interest in such property of an entity other than the estate" only if: (1) "applicable nonbankruptcy law permits sale of such property free and clear of such interest"; (2) "such entity consents"; (3) "such interest is a lien and the price at which such property is to be sold is greater than the aggregate value of all liens on such property"; (4) "such interest is in bona fide dispute"; or (5) "such entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest."[525] Section 363(f) is limited to "any interest in such property." Notably, this

[524] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[525] 11 U.S.C. § 363(f).

language is different from that used in section 1141(c), which speaks to "property dealt with by the plan [being] free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor."[526]

The legislative history of section 363(f) provides little guidance on the scope of the term "interest," other than to acknowledge that a lien should be considered an interest in property.[527] Courts interpreting this section have taken two general approaches: the first construes section 363(f) narrowly and limits its application to liens, security interests, mortgages, and money judgments;[528] and the second takes a more expansive view of interests and captures claims against the debtor or estate property, including successor liability claims, discrimination claims, personal injury claims, and other "claims" within the meaning of section 101(5) of the Bankruptcy Code.[529] Some courts and commentators argue that the expansive approach is necessary to facilitate sales under section 363(f) and to achieve the underlying policy objectives of the Bankruptcy Code.[530]

Courts also take different approaches to whether a debtor in possession has satisfied one of the grounds set forth in section 363(f) to support a sale free and clear of interests in the property.[531] For example, some courts require the sale price to exceed the face value of secured claims asserted against the property to satisfy section 363(f)(3).[532] Other courts require only that the sale price exceed the economic value of the creditors'

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[526] *Id.* § 1141(c).

[527] The legislative history provides, in relevant part:

> At a sale free and clear of other interests, any holder of any interest in the property being sold will be permitted to bid. If that holder is the high bidder, he will be permitted to offset the value of his interest against the purchase price of the property. Thus, in the most common situation, a holder of a lien on property being sold may bid at the sale, and if successful, may offset the amount owed to him that is secured by the lien on the property (but may not offset other amounts owed to him) against the purchase price, and be liable to the trustee for the balance of the sale price, if any.

H.R. Rep. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6302; S. Rep. 95-989 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5842.

[528] *See, e.g., In re* White Motor Credit Corp., 75 B.R. 944, 948 (Bankr. N.D. 1987); *In re* New England Fish Co., 19 B.R. 323, 329 (Bankr. W.D. Wash. 1982).

[529] *See, e.g., In re* Trans World Airlines, Inc., 322 F.3d 283, 289 (3d Cir. 2003) ("[T]he trend seems to be toward a more expansive reading of 'interests in property' which 'encompasses other obligations that may flow from ownership of the property'") (citing 3 Collier on Bankruptcy ¶ 363.06[1]); *In re* WBQ P'ship, 189 B.R. 97, 105, (Bankr. E.D. Va. 1995).

[530] *See, e.g., In re* Trans World Airlines, Inc., 322 F.3d 282, 290 (3d Cir. 2003) (suggesting a trend toward an expansive view of section 363(f) to include claims); Folger Adam Sec., Inc. v. DeMatteis/MacGregor, JV, 209 F.3d 252 (3d Cir. 2000) (holding that pursuant to section 363(f), the debtors' contractual payment rights was free and clear of a contractor's previously unexercised setoff rights, but was not free and clear of the contractor's recoupment rights because by their very nature, recoupment rights simply cannot be considered an "interest" in property extinguished by a section 363(f) free-and-clear sale"); *In re* Tougher Indus., Inc., 2013 WL 1276501, at *6 (Bankr. N.D.N.Y. Mar. 27, 2013).

[531] *See generally* George W. Kuney, *Misinterpreting Bankruptcy Code Section 363(f) and Undermining the Chapter 11 Process*, 76 Am. Bankr. L.J. 235, 244 (2002).

[532] *See, e.g.*, Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 40–41 (B.A.P. 9th Cir. 2008). *See also* Criimi Mae Servs., Ltd. P'ship v. WDH Howell, LLC (*In re* WDH Howell, LLC), 298 B.R. 527, 534 (D.N.J. 2003). *See also* Robert M. Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, Bankr. L. Letter, Oct. 2008, at 7 ("Although the result in *Clear Channel* will be controversial, its specific holding on section 363(f)(3) should not be. Its reasoning is compelling on the statutory language, and it reaches a result well within the mainstream of other court decisions. To sell free and clear under section 363(f)(3), the sales price must exceed the total value of all liens regardless of whether those are totally secured or undersecured.") (citations omitted).

allowed secured claims under section 506.[533] Courts also disagree as to what constitutes a bona fide dispute for purposes of section 363(f)(4).[534] They also have taken different approaches to whether the language in section 363(f)(5) providing that the "entity could be compelled, in a legal or equitable proceeding, to accept a money satisfaction of such interest" includes a cramdown of a chapter 11 plan under section 1129(b).[535]

b. Transactions Free and Clear of Interests: Recommendations and Findings

The Commissioners analyzed section 363(f) of the Bankruptcy Code and the concept of sales "free and clear" of liens, interests, and claims. They reviewed the original focus of that section on "interests" in estate assets, and they discussed the expansion of that concept to claims of various kinds. The Commissioners identified different kinds of claims that courts have included within section 363(f), including litigation claims, discrimination claims, and successor liability claims. The Commission agreed that this expansive approach to section 363(f) fostered more competition for the debtors' assets and likely enhanced the value of the assets sold through the section 363(f) sale process. The Commissioners questioned whether the historical nexus between "free and clear" sales under section 363(f) and in rem notions of property interests still served bankruptcy policy.

To analyze this question, the Commission considered the language and purpose of section 1141(c) of the Bankruptcy Code and the inclusion of claims in the discharge injunction in connection with a chapter 11 plan. The Commissioners suggested that this difference may relate to the more significant notice and due process provided to creditors in the plan process. Although creditors holding general unsecured claims (including the kinds of litigation and other claims mentioned above) do not have any particular interest in the debtor's property, they receive notice and an opportunity to object to the treatment of their claims under the plan. In the section 363 context, such creditors may or may not receive notice of the sale motion or an opportunity to object.

The Commissioners evaluated whether this difference in process should preclude an expansive reading of section 363(f) that would include liens, interests, and claims. With respect to single asset sales or smaller transactions, the Commission agreed that the notice currently required by the Bankruptcy Rules was likely sufficient, as assets

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[533] *See, e.g.*, WBQ P'ship v. Va. Dep't of Med. Assistance Servs. (*In re* WBQ P'ship), 189 B.R. 97, 105–06 (Bankr. E.D. Va. 1995); *In re* Beker Indus. Corp., 63 B.R. 474, 475–76 (Bankr. S.D.N.Y. 1986).

[534] *See, e.g.*, Union Planters Bank v. Burns (*In re* Gaylord Grain LLC), 306 B.R. 624 (B.A.P. 8th Cir. 2004).

[535] *See, e.g.*, Clear Channel Outdoor, Inc. v. Knupfer (*In re* PW, LLC), 391 B.R. 25, 46 (B.A.P. 9th Cir. 2008). *See also* Lawless, *BAP Prohibits Sale Free and Clear of an Underwater Junior Lien*, *supra* note 532, at 8 ("Instead of the Chapter 11 cramdown, a state foreclosure proceeding would seem to be a proceeding where the second lienholder could be compelled to accept a monetary satisfaction of its lien and thus satisfy the requirements of (f)(5). Indeed, the word 'foreclosure' means exactly that — the foreclosure of junior interests. A hypothetical state foreclosure proceeding seems so obvious that one wonders why the BAP [in *Clear Channel*] did not simply take judicial notice of it to hold that (f)(5) was satisfied. Perhaps the court's concern was the lack of a solid record on how the foreclosure sale process would play out and specifically what value the property would bring at a foreclosure sale, although the bidding at the bankruptcy court would again seem to be an obvious place to look for the value of the property. The concern about the lack of a record perhaps can be seen in the BAP's references to 363 sales being used to bypass the more procedurally robust confirmation requirements of section 1129 that could protect third-party rights.") (citations omitted).

remained in the estate to potentially fund claims through a chapter 11 plan. In a sale of all or substantially all of a debtor's assets, however, the calculus may be different. On that point, the Commissioners noted that these principles recommend notice and due process procedures similar to what creditors are entitled to in the plan context. Accordingly, under the principles applicable to section 363x sales, creditors holding the kinds of claims subject to section 363(f) under the expansive view would receive notice and an opportunity to object to the proposed sale.

The Commissioners were also persuaded that permitting the debtor in possession to transfer clean title to a purchaser under section 363(f) held potentially significant value for the estate. To that end, the Commissioners analyzed the conflicting interpretations of certain subsections of section 363(f) and identified approaches that would foster a competitive sale process while still protecting creditors' rights against the estate. The Commission agreed that the scope of section 363(f)(1) and (5) should be clarified to focus on the property owner's rights under applicable nonbankruptcy law. The Commission also determined, however, that these ambiguities and perceived barriers to free and clear transfers in a chapter 11 case would likely be mitigated by its recommended change to section 363(f)(3). With the additional notice and process being recommended in the context of sales of all or substantially all of the debtor's assets, the Commission determined that adopting an expansive view of section 363(f) was warranted and adequately protected the interests of stakeholders.

The Commissioners further considered whether any particular liens, interests, or claims should be excluded from section 363(f) under this expansive approach. They methodically evaluated different kinds of claims and interests. They decided that the debtor in possession should be able to transfer property free and clear of all liens, interests, and claims, including without limitation: civil rights liabilities; successor liability in tort; and successor liability in contract. The Commissioners also concluded that the debtor in possession should not be able to transfer property free and clear of the following: easements, covenants, use restrictions, usufructs, or equitable servitudes that run with the land; environmental liabilities and related social policies that run with the land; successorship liability under federal labor laws; and partial, competing or disputed ownership interests, except to the extent specified in section 363(h) or (i). Moreover, the Commissioners recognized that a debtor in possession should not be able to sell or transfer assets under section 363(f) in a manner that violates or impedes the police or regulatory power of the federal government or a state government to the extent that such government could enforce those rights against the debtor in possession or estate property during the case, notwithstanding section 362(a) of the Bankruptcy Code. The Commission thus recommended that section 363(f) recognize the government's police and regulatory powers to the extent such powers would be enforceable under section 362(b)(4).

4. Credit Bidding

Recommended Principles:

- In a sale under section 363 of the Bankruptcy Code involving a secured creditor's collateral, the secured creditor should be permitted to credit bid up to

> the amount of its allowed claim relating to such collateral unless the court orders otherwise for cause. For purposes of this principle, the potential chilling effect of a credit bid alone should not constitute cause, but the court should attempt to mitigate any such chilling effect in approving the process. Section 363(k) should be clarified accordingly.

a. Credit Bidding: Background

A creditor with a perfected lien in the debtor's property has certain rights and remedies against the debtor and property within the creditor's collateral package. Among other things, the secured creditor can credit bid the amount of its allowed claim in any sale of its collateral. A secured creditor's right to credit bid exists under both state law and section 363(k) of the Bankruptcy Code. Section 363(k) provides: "At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property."[536]

A credit bid allows the secured creditor to purchase the property constituting its collateral if other bidders are not willing to pay sufficient value or the creditor prefers to possess the collateral in lieu of payment. The secured creditor also does not need to pay any cash for the property at the sale to the extent the allowed amount of its claim is sufficient to cover the price of its winning bid. Rather, the secured creditor can set off its secured claim against the debtor or the property against the purchase price it otherwise would be required to pay the estate.[537]

Although credit bidding is an integral part of the secured creditors' rights package, it is not without limit. Specifically, section 363(k) allows the court to limit a secured creditor's credit bid for cause.[538] Courts typically have found cause to limit a credit bid if the amount of the secured creditor's claim is disputed or unliquidated.[539] Courts also have found cause to limit a credit bid, however, based on the conduct of the secured creditor. For example, *In re Free Lance-Star Publishing Co.*, the court held that the secured creditor did not have the right to credit bid on assets that did not secure its allowed claim and found cause to limit the creditor's right to credit bid at the auction based on, among other things, the creditor's "overly zealous loan-to-own strategy," in which the creditor acquired the loan for the sole purpose of obtaining the right to credit bid at an expedited sale of the debtor's assets and discouraged any competitive

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[536] 11 U.S.C. § 363(k).

[537] *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) (providing historical overview and describing the evolution of credit bidding in bankruptcy), *available at* Commission website, *supra* note 55.

[538] 11 U.S.C. § 363(k) ("At a sale under subsection (b) of this section of property that is subject to a lien that secures an allowed claim, unless the court for cause orders otherwise the holder of such claim may bid at such sale, and, if the holder of such claim purchases such property, such holder may offset such claim against the purchase price of such property.").

[539] *See, e.g.*, *In re* RML Dev., Inc., 2014 WL 3378578 (Bankr. W.D. Tenn. July 10, 2014) (valid claims objection that could not be resolved without delaying auction was cause to limit amount of credit bid).

bidding.[540] Similarly, in *Fisker Automotive Holdings*, the court found cause to limit the secured creditor's ability to credit bid the entire amount of its secured claim because the amount was uncertain, and allowing the creditor to credit bid its entire claim would freeze out all competitive bidding by attractive and capable bidders.[541]

b. Credit Bidding: Recommendations and Findings

The Commission considered credit bidding under section 363(k) in light of recent case law developments and an arguably expanded application of the cause standard for limiting credit bids. The Commissioners discussed the fundamental role of credit bidding under state law and section 363(k).[542] They also acknowledged that all credit bidding chills an auction process to some extent. Accordingly, the Commissioners did not believe that the chilling effect of credit bids alone should suffice as cause under section 363(k).

The Commissioners noted that, in some cases, it may be difficult to discern any chilling effect caused by the credit bid itself from a chilling effect resulting from the conduct of the secured creditor seeking to exercise its right to credit bid. For example, the Commissioners discussed situations in which the secured creditor demands a relatively short period to market the property and conduct the sale, requires the marketing materials to highlight the secured creditor's right to credit bid, or takes other actions to discourage a competitive bidding process. The Commission agreed that such conduct could, in fact, depress the value of the property and preclude the estate from receiving any return from the sale.[543] The Commissioners, however, did not want to endorse a principle that would suggest that the chilling effect of a credit bid warrants restrictions on the right to credit bid.[544] The Commission ultimately agreed to maintain

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[540] *In re* Free Lance-Star Publ'g Co. of Fredericksburg, Va., 512 B.R. 798 (Bankr. E.D. Va. 20141), *appeal denied*, 512 B.R. 808 (E.D. Va. 2014).

[541] *In re* Fisker Auto. Holdings, Inc., 510 B.R. 55 (Bankr. D. Del. 2014), *appeal denied*, 2014 WL 576370 (D. Del. Feb. 12, 2014).

[542] *See, e.g.*, Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News, *supra* note 43, at 3 ("For secured creditors, operating on the assumption that in a free-and-clear sale of its collateral the sale price itself establishes the value of the collateral, credit bidding serves two protective functions — both as an undervaluation protection and a proceeds protection. Not only can the undersecured creditor bid in its claim to acquire the assets when it believes the otherwise prevailing sale price is too low, the undersecured creditor can also bid in its claim to acquire the assets when it believes that the proposed plan would not return to the undersecured creditor the full value of the proceeds generated by sale (*i.e.*, the value) of its collateral."); Ralph Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, Bankr. L. Letter, July 2012, at 8 ("[T]the legislative record indicates that the Code drafters also considered the credit bidding rights separately codified in § 363(k) to be an integral component of adequately protecting the secured creditor's lien rights."). "By holding that a dissenting secured creditor must be afforded credit-bidding rights under § 363(k) in any free-and-clear sale of its collateral under a plan of reorganization, RadLAX ensures that secured creditors have the same credit-bidding rights in plan sales that they have in § 363 sales." *Id.*

[543] *See, e.g.*, Brubaker, *The Post-RadLAX Ghosts of* Pacific Lumber *and* Philly News, *supra* note 43, at 4 ("When the undersecured creditor's collateral is the entirety of the debtor's assets, therefore, credit-bidding rights in any going-concern sale of the debtor's business and assets give that senior secured creditor the leverage to always insist upon capturing all of the debtor's reorganization surplus, to the detriment of unsecured creditors and other junior classes.").

[544] *Written Statement of Danielle Spinelli, Partner, WilmerHale, TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 3, 2012) ("To the extent that the argument here is that cash bidders will be chilled because they fear that a secured creditor may outbid them, it lacks force. That would be equally true of any

the current standard under section 363(k), with the recommendation that the chilling effect of a credit bid not be deemed sufficient cause to limit a credit bid, but that courts should attempt to mitigate any chilling effect through the auction and sale procedures approved in the case.

C. Avoiding Powers

1. Preference Claims

Recommended Principles:

- The trustee's ability to pursue preference claims under section 547 of the Bankruptcy Code preserves value for the estate and tempers the "run on the debtor" that may occur immediately prior to a bankruptcy filing. The avoiding power in section 547 may, however, be subject to abuse in certain cases. The Commission analyzed a variety of potential reforms to section 547, including refining elements of, or shifting the burden of proof for, certain defenses under section 547(c). After much research and deliberation, the Commission determined that the potential abuses under section 547 are addressed most effectively through the changes in small preference actions, pleading requirements, and demand requirements described in these principles, and continued judicial oversight in accordance with the Bankruptcy Code.
- The trustee should be precluded from issuing a demand letter to, or filing a complaint against, any party for an alleged claim under section 547 unless, based on reasonable due diligence, the trustee believes in good faith that a plausible claim for relief exists against such party under section 547, taking into account the party's known or reasonably knowable affirmative defenses under section 547(c).
- The trustee must plead with particularity factual allegations in the complaint that establish a plausible claim for relief under section 547. In accordance with the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly*, 550 U.S. 544 (2007), and *Ashcroft v. Iqbal*, 556 U.S. 662 (2009), legal conclusions or speculative allegations should not be sufficient to support a preference complaint.
- The dollar amount of the defense against preference claims provided in section 547(c)(9) should be increased to $25,000 in the aggregate. This dollar amount should continue to be increased based on the Consumer Price Index for All Urban Consumers under section 104(a).
- The small claims venue provision in 28 U.S.C. § 1409(b) should be amended to (i) clarify that the section applies to preference actions under section 547 and (ii) increase the dollar limit for debts (excluding consumer debts) against noninsiders to $50,000 in the aggregate. This dollar amount

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deep-pocketed bidder, and no auction can afford to exclude the bidders with the greatest resources on the ground that they might outbid everyone else."), *available at* Commission website, *supra* note 55.

should continue to be increased based on the Consumer Price Index for All Urban Consumers under section 104(a).

a. Preference Claims: Background

The concept of preference law dates back to the 1584 English King's Bench decision, *The Case of Bankrupts* (finding post-petition transfers ineffective against a bankrupt's estate)[545] and the 1768 decision of *Alderson v. Temple* (authorizing the recovery of property preferred to a particular creditor).[546] Since that time, the law has undergone numerous variations with regard to the underlying purpose of the transfer, the necessary intent of the parties, and the insolvent state of the debtor at the time of the transfer. In 1978, Congress revised the preference law to omit the requirement that the trustee[547] establish that the creditor had reasonable cause to believe the debtor was insolvent, in exchange for the reduction of the noninsider reachback period from 120 to 90 days and the addition of a 90-day presumption of insolvency.

The primary goals of preference law are (i) to equalize distribution and (ii) to maximize estate value.[548] It seeks to achieve these goals through property recapture and deterrence.[549] Under the Bankruptcy Code's original conception of preference law, the trustee could recover payments or property transferred to creditors pre-petition to the extent those transfers preferred such creditors over other similarly situated creditors (typically general unsecured creditors).[550] The trustee would then distribute the recovered value to all similarly situated creditors. Even the creditors from which the trustee recovered preferences were, in many instances, entitled to receive a pro rata share of the recovered value.[551]

Since 1978, the application of preference law has changed. Some commentators question whether preference law continues to serve its original goals.[552] These commentators suggest that preference law is not an effective deterrent and does not necessarily equalize distributions. In fact, anecdotal evidence shows that, in many cases, the value of preference recoveries no longer is reallocated among general unsecured creditors. Rather, secured creditors are granted liens in preference claims and recoveries as part of adequate protection, cash collateral, or debtor in possession

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[545] 7 Eng. Rep. 441 (K.B. 1584).

[546] 96 Eng. Rep. 384 (K.B. 1768).

[547] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[548] John C. McCoid, *Bankruptcy, Preferences, and Efficiency: An Expression of Doubt*, 67 Va. L. Rev. 249, 261 (1981).

[549] *Id.* at 262.

[550] *See, e.g.*, G.H. Leidenheimer Baking Co., Ltd. v. Sharp *(In re* SGSM Acquisition Co., LLC), 439 F.3d 233, 238 (5th Cir. 2006) ("The theory is that when the preferential payments are returned, all creditors can share ratably in the debtors' assets, and the race to the courthouse, or the race to receive payment from a dwindling pre-bankruptcy estate, will be averted.").

[551] For examples of statutory authority for such distributions, see Section 57g of the Bankruptcy Act and section 502(h) of the Bankruptcy Code.

[552] *See, e.g.*, Brook E. Gotberg, *Conflicting Preferences in Business Bankruptcy: The Need for Different Rules in Different Chapters*, 100 Iowa L. Rev. 51 (2014).

financing orders in the case.[553] Alternatively, the estate may not have sufficient resources to pay administrative and priority claims in the case, and the trustee applies preference recoveries to these claims.[554] Moreover, trustees may pursue preference claims in situations in which a cost-benefit analysis indicates little value for the estate, but significant cost and burden for the targeted creditors.

b. Preference Claims: Recommendations and Findings

Preference law is one aspect of a chapter 11 case that affects creditors on an individual basis. Unlike other aspects of bankruptcy law that generally affect creditors' rights, preference law challenges transfers made to a particular creditor and may require that creditor to disgorge pre-petition payments to the estate. The Commissioners acknowledged that from the unsecured creditor's perspective, preference law appears unfair and potentially increases the losses by that particular creditor as a result of the chapter 11 case, particularly if preference recoveries are not available to pay general unsecured claims.

The Commission reviewed the testimony from the various public hearings, which evidenced strong frustrations with preference law. Witnesses testified that some trustees pursued preference actions with little diligence and without regard to the merits of the underlying claim.[555] They suggested that, at least from an outside perspective, some trustees appear to file preference actions not necessarily to recover the alleged preference, but to extract a settlement payment.[556] The Commissioners discussed

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[553] Terry Brennan, *Miller: Liquidations Set to Rise*, The Deal, Dec. 2, 2003, *available at* 2003 WLNR 4666298; Kenneth N. Klee & Richard Levin, 21 Norton J. Bankr. L & Prac. 5, §§ 3.0, 3.6 (Nov. 2012); s*ee* Thomas D. Goldberg, *Curbing Abusive Preference Actions — Rethinking Claims on behalf of Administratively Insolvent Estates*, Am. Bankr. Inst. J., May 2004, at 14. *See also In re* Furr's Supermarkets, Inc., 373 B.R. 691, 697 (B.A.P. 10th Cir. 2007) (proceeds of avoidance actions split between secured lender and administrative claims); Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290, 294 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (proceeds of avoidance actions used solely to pay claims of secured lenders); *In re* Payless Cashways, Inc., 290 B.R. 689, 696–97 (Bankr. W.D. Mo. 2003) (preference action recoveries solely to satisfy administrative claims).

[554] Companies increasingly utilize easy to obtain prepetition financing, through mezzanine funding, leveraged lending, second lien debt, and securitization, such that potential debtors are now contemplating bankruptcy with extremely leveraged balance sheets. As a result, little, if any, unencumbered collateral is often available to offer prospective DIP lenders. *See* Stephen A. Donato & Thomas L. Kennedy, *Trends in DIP Financing: Not as Bad as It Seems?*, J. Corp. Renewal, Sept/Oct. 2009, ¶¶ 11–12, *available at* http://www.turnaround.org/Publications/Articles.aspx?objectId=11602. *See also* Goldberg, *supra* note 553, at 14.

[555] *See Oral Testimony of Kathy Tomlin: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27–29 (May 21, 2013) (NACM Transcript) (noting how she spends tremendous time and resources successfully defending preference actions and arguing that trustees and debtors should have an obligation to evaluate preference claims and defenses before making a repayment demand), *available at* Commission website, *supra* note 55; *Oral Testimony of Joe McNamara: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 12 (May 21, 2013) (NACM Transcript) (providing specific example of time and costs associated with preference action in a particular case), *available at* Commission website, *supra* note 55.

[556] *See Oral Testimony of Valerie Venable: NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 34–37 (May 21, 2013) (NACM Transcript) ("The trustee knows [that preference defense] is going to get expensive to me to continue to defend and is counting on a monetary settlement just to get rid of them."), *available at* Commission website, *supra* note 55.

different options for addressing these concerns and enhancing the efficiency of the preference process,[557] as well as the potential abuses associated with each.[558]

Under section 547 of the Bankruptcy Code, the trustee currently bears the burden of proving the elements of a preference claim under section 547(b), and then the creditor bears the burden of proving one of the affirmative defenses contained in section 547(c). The Commission considered supplementing the elements of section 547(a) with an affirmative statement concerning diligence performed to evaluate the merits of the preference claim in light of any section 547(c) defenses available to the creditor. Alternatively, some of the Commissioners suggested a presumption in favor of the creditor that the pre-petition transfer was in the ordinary course of business, which the trustee could rebut as part of its prima facie case.[559] Although the Commissioners found potential utility in each option, they raised concerns regarding a trustee's ability to obtain information sufficient to make affirmative statements or rebut such a presumption as part of its prima facie case. Some of the Commissioners noted that, in many cases, the books and records of the debtor do not provide the information necessary to make these assessments at the outset, and that trustees typically perform due diligence and make good faith attempts to assess the merits of the potential preference action before filing the complaint against, or issuing a demand letter to, the creditor. These Commissioners acknowledged the concerns of the hearing witnesses, but believed those represented the exception rather than the rule concerning a trustee's pursuit of preference claims. The Commission reviewed the steps commonly taken by trustees in evaluating preference claims to try to develop a threshold standard that would not be unduly burdensome on trustees, but also would provide some protection to creditors in the process.

The Commission ultimately determined that codifying a standard that required the trustee to perform reasonable due diligence and to make good faith efforts to evaluate the merits of the preference claim was a reasonable compromise. It also agreed that the statute should require the trustee to plead with particularity in the complaint the facts

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[557] The Commissioners also discussed eliminating the preference statute in its entirety but that principle was rejected. The Commissioners agreed that any such elimination would only accelerate the prepetition depletion of a debtor's assets.

[558] *In re* Ames Dep't Stores, Inc., 450 B.R. 24 (Bankr. S.D.N.Y. 2011), *aff 'd*, 470 B.R. 280 (S.D.N.Y. 2012), *aff'd*, 506 Fed. App'x 70 (2d Cir. 2012), *cert. denied*, 134 S. Ct. 65 (2013).

[559] *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 12 (Nov. 15, 2012) ("Since 1978, it has become common in cases of any size that post-confirmation liquidation trustees or post-conversion chapter 7 trustees assert claims against all creditors who received payments from the debtor within 90 days before the commencement of the case that those payments may be avoidable preferences. In some, but not all, such cases, the trustees at least perform new value analyses and claim only the net balance; in virtually no cases do the trustees assess the likelihood of an ordinary course defense. There are usually exchanges of letters and spreadsheets resulting in settlements for a fraction of the amount of the original claims. Often, the creditors settle for nuisance value just to avoid the costs of litigation. This practice imposes costs on creditors vastly disproportionate to the gain to estates, and is particularly difficult for factors who do not have direct access to the original vendors' records. Since factors are a major source of financing for small and medium sized firms, this burden should be of concern to everyone. Requiring the trustees to plead that challenged transfers were not in the ordinary course or subject to new value setoff would reduce the number and burden of weak claims without imposing undue burdens on the trustees. The same records that allow the trustees to identify the payments they question would also allow them to assess sufficiently for Rule 9011 purposes the ordinary course and new value issues at little additional cost to them. On the other hand, the savings to factors and other creditors that would result from weeding out weak claims before they are even asserted would be substantial."), *available at* Commission website, *supra* note 55.

supporting each element of the preference claim under section 547(b), in accordance with the U.S. Supreme Court's decisions in *Bell Atlantic Corp. v. Twombly* and *Ashcroft v. Iqbal*,[560] which provide that legal conclusions or speculative allegations should not be sufficient to support a complaint. Finally, the Commission recommended increasing the monetary caps in section 547(c)(9) of the Bankruptcy Code and section 1409(b) of title 28 of the U.S. Code (the small claims venue provision) to $25,000 and $50,000, respectively (indexed in accordance with section 104(a) of the Bankruptcy Code). The Commission voted to recommend these three changes. The Commissioners firmly believed that these changes collectively would mitigate many of the perceived or actual abuses in the preference process.

The Commission also reviewed the potential impact of fee shifting or sanctions in the context of preference litigation. Many of the Commissioners did not support a straight "loser pays" rule, as it could penalize preference defendants in close cases when the claims were disputed and the creditor loses. The Commissioners were also concerned about requiring the estate to pay when the trustee loses on a preference claim because of the nature of preference litigation, which often is uncertain and involves trustees initially working with limited information, and the harm to other beneficiaries of the estate. The Commission determined that neither fee shifting nor sanctions were warranted or workable in the preference context.

2. Recoveries Under Section 550

Recommended Principles:

- The trustee should be permitted to name an alleged subsequent transferee as a defendant in the original complaint to avoid any transfer under Bankruptcy Code section 544, 545, 547, 548, 549, or 553(b), and to recover such property under section 550. If any alleged subsequent transferee is not named as a defendant in the original complaint, the trustee should be required to sue such transferee in a subsequent action under section 550, and such transferee should have the ability to raise any and all defenses, including those relating to the original avoidance action, in that litigation. Section 550 should be amended accordingly.
- The term "for the benefit of the estate" under section 550(a) should be interpreted broadly to permit recoveries for the benefit of "all creditors according to their statutory and contractual entitlements." *Mellon Bank, N.A. v. Dick Corp.*, 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004). This interpretation of section 550(a) should include all creditors, including administrative claimants and pre-petition equity security holders, but should not include lenders under a post-petition financing facility. See Section IV.B, *Financing the Case*. It also should not expand or otherwise affect the underlying causes of action that a trustee must establish prior to seeking recoveries under section 550.

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[560] Bell Atlantic Corp. v. Twombly, 550 U.S. 544 (2007); Ashcroft v. Iqbal, 556 U.S. 662 (2009).

> • The trustee should be able to file an action under chapter 5 of the Bankruptcy Code to avoid and recover transfers occurring outside the United States to the same extent it could file such an action with respect to domestic transfers. In reviewing any avoidance action involving transfers occurring solely outside the United States, the court should consider whether allowing such action to proceed is consistent with general principles of comity and is reasonably necessary to protect the interests of the estate, considering the expectations of the defendants, the laws of the foreign jurisdiction, and the relief available to the trustee in the foreign jurisdiction.

a. Recoveries Under Section 550: Background

Section 550 of the Bankruptcy Code complements the trustee's chapter 5 avoiding powers by allowing the trustee [561]to recover the property involved in, or the value of, any avoided transfers.562 For example, a debtor in possession may avoid preferential transfers under section 547 or fraudulent transfers under section 548 or 544(b) and then seek to recover the security interest, lien, asset, or money transferred in those avoided transactions under section 550. Specifically, section 550(a) provides as follows:

> (a) Except as otherwise provided in this section, to the extent that a transfer is avoided under section 544, 545, 547, 548, 549, 553(b), or 724(a) of this title, the trustee may recover, for the benefit of the estate, the property transferred, or, if the court so orders, the value of such property, from —
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> (1) the initial transferee of such transfer or the entity for whose benefit such transfer was made; or
>
> (2) any immediate or mediate transferee of such initial transferee.[563]

Section 550 establishes a two-step process: the debtor in possession first files a complaint to avoid the subject transfer or transaction; and then, after the court grants the relief requested by the complaint, the debtor in possession files a separate action to recover the property (or the value of the property) involved in the avoided transfer or transaction. Although the debtor in possession may assert the avoidance action and the recovery action against the transferee in the same complaint, the language of the statute suggests that a separate action must be filed against any subsequent transferees.[564] Some courts also are uncertain whether a debtor in possession is authorized to seek to recover property from foreign subsequent transferees under section 550.[565]

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[561] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[562] 11 U.S.C. § 550.

[563] *Id.*

[564] *Id.*

[565] *See* Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 2014 U.S. Dist. LEXIS 91508 (S.D.N.Y. July 6, 2014).

In addition, courts are divided concerning the interpretation of the phrase "for the benefit of the estate" as used in section 550.[566] Some courts interpret the phrase broadly, permitting recovery as soon as there is some identifiable benefit to the estate.[567] Other courts utilize a narrower interpretation, restricting recoveries to those circumstances in which a more direct benefit to creditors (at times, specifically unsecured creditors) can be shown.[568]

The Fifth, Seventh, and Tenth Circuits, as well as certain lower courts within those Circuits, interpret section 550 broadly.[569] These courts hold that there is a benefit to the estate when any interested party in a bankruptcy case stands to benefit from avoidance action recoveries.[570] The term "interested party" has been interpreted not only to include secured creditors, unsecured creditors, and administrative claimants,[571] but also equity security holders.[572] In addition, the benefit to the estate does not need to be direct, but may arise indirectly by, for example, increasing the likelihood of effectuating a successful reorganization or meeting payment obligations under a plan.[573]

Courts narrowly interpreting section 550(a) do not require an absolute direct benefit to unsecured creditors, but they generally require a more direct benefit to those creditors than do courts that employ the broader interpretation.[574] For example, the Eighth

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[566] *See e.g.*, *In re* Acequia, Inc., 34 F.3d 800, 811–12 (9th Cir. 1994).

[567] *In re* C.W. Mining Co., 477 B.R. 176, 189 (B.A.P. 10th Cir. 2012), *aff 'd*, 749 F.3d 895 (10th Cir. 2014) (explaining that the phrase "for the benefit of the estate," as used in section 550, should be construed broadly, rather than narrowly, to include indirect benefits). *See also* Weaver v. Aquila Energy Marketing Corp., 196 B.R. 945, 956 (S.D. Tex. 1996) (noting that section 550's "benefit" requirement is satisfied as soon as there is some identifiable benefit to the estate).

[568] *See In re* Burlington Motor Holdings, Inc., 231 B.R. 874, 877 (Bankr. D. Del. 1999) (holding that "any recovery of preferences in this case will benefit only the Successor Corporation" and that "unsecured creditors must be benefitted by recovery") (citing *In re* Resorts Int'l, Inc., 145 B.R. 412, 474–75 (Bankr. D.N.J. 1990)); Harstad v. First Am. Bank, 39 F.3d 898, 905 (8th Cir. 1994) (holding that " increas[ing] the likelihood that [debtors] will be able to pay their creditors as the Plan requires, even though it will not increase the amount paid to the creditors" is insufficient benefit to the estate to permit recovery under section 550(a)).

[569] Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (holding that the term "estate," as used in section 550(a), means the set of all potentially interested parties, and not any one particular class of creditors); *In re* NETtel Corp., Inc., 364 B.R. 433, 442 (Bankr. D.C. 2006); *In re* Furrs, 294 B.R. 763, 783 (Bankr. D. N.M. 2003).

[570] *See* MC Asset Recovery LLC v. Commerzbank A.G. (*In re* Mirant Corp.), 675 F.3d 530, 532–34 (5th Cir. 2012); Mellon Bank, N.A. v. Dick Corp., 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004); *In re* NETtel Corp., Inc., 364 B.R. 433, 442 (Bankr. D. D.C. 2006).

[571] Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A., Ltd. (*In re* Payless Cashways, Inc.), 290 B.R. 689, 696–97 (Bankr. W.D. Mo. 2003) (holding that a chapter 11 trustee had standing to pursue preference claims even though recoveries would go solely to satisfy administrative claims).

[572] *See* Kipperman v. Onex Corp., 411 B.R. 805, 876–88 (N.D. Ga. 2009) (holding that all interests, including those of all creditors and equity security holders, are comprised in the estate); *In re* Bayou Grp., LLC, 372 B.R. 661, 664 n.2 (Bankr. S.D.N.Y. 2007) (refusing to adopt a bright-line rule that avoidance actions can never be brought in whole or in part for the benefit of equity security holders).

[573] *In re* P.A. Bergner & Co., 140 F.3d 1111, 1118 (7th Cir. 1998), *cert. denied*, 525 U.S. 964 (1998) (explaining that though preference action recovery will benefit reorganized debtor and thus owners of reorganized debtor, recovery under section 550(a) is permissible because owners of reorganized debtor were the largest creditor group of old debtor, so benefit to these creditors provides a sufficient benefit to the estate to satisfy the requirements of section 550); *In re* Furrs, 294 B.R. 763, 780 (Bankr. D.N.M. 2003) (holding that "an action which will generate funds for the payment of administrative claims is a proper use of [t]rustee's avoiding and recovery powers"). *See also* Weaver v. Aquila Energy Marketing Corp., 196 B.R. 945, 956 (S.D. Tex. 1996) (holding that section 550's "benefit" requirement is satisfied as soon as there is some identifiable benefit to the estate).

[574] *See, e.g.*, *In re* Acequia, Inc., 34 F.3d 800, 811 (9th Cir. 1994) (allowing recovery of fraudulent transfers even though creditors have been paid in full when recovery would aid continuing performance under plan and pay

Circuit[575] and the Bankruptcy Court for the District of Delaware[576] have interpreted section 550(a) as effectively requiring that the contemplated recovery be somehow targeted, or legally tied, to the benefit of creditors (e.g., pursuant to a plan in which avoidance action proceeds are distributed or in a settlement under Bankruptcy Rule 9019). In both cases, the courts found that the demonstrated benefit was insufficient to permit recovery under section 550(a).[577]

b. Recoveries Under Section 550: Recommendations and Findings

The Commission reviewed several issues relating to avoidance action recoveries under section 550. This section of the Bankruptcy Code is an integral component of the trustee's avoiding powers under chapter 5 of the Bankruptcy Code. It essentially represents the mechanism by which the trustee can recover any value resulting from avoidance actions for the estate. Recognizing the section's importance in the avoidance process and the need to provide a clear, efficient, and fair path to recoveries, the Commissioners discussed the actual mechanics of section 550.

Several Commissioners commented on the sometimes cumbersome process of suing on the underlying avoidance action and then bringing the recovery action under section 550 after the fact. Many of the Commissioners believed that providing subsequent transferees with at least notice of the underlying avoidance action and an opportunity to intervene would improve this system. This kind of notice would prevent duplicative litigation when no notice is provided, and a subsequent transferee disputes the existence of a valid cause of action. Others suggested requiring the trustee to name any potential subsequent transferees as defendants in the underlying avoidance action. Some of the Commissioners questioned whether such a requirement was feasible, because often the identity of any subsequent transferees is discovered in the litigation on the underlying avoidance claim and is not necessarily known to the trustee at the time of filing the complaint. Notice would not be possible in those cases.

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administrative creditors because "[c]ourts construe the 'benefit to the estate' requirement broadly, permitting recovery under section 550(a) even in cases where distribution to unsecured creditors is fixed by a plan of reorganization and in no way varies with recovery of avoidable transfers"); Harstad v. First Am. Bank, 39 F.3d 898, (8th Cir. 1994) ("We do not hold that a bankruptcy trustee or a debtor in possession (or a debtor or an appointed representative under powers reserved via § 1123(b)(3)) must demonstrate a direct benefit to the creditors in the form of a distribution to the creditors of the preference recovery (although that would certainly make this a much easier issue to decide). Nevertheless, we do hold that those wishing to bring preference actions must show a more definite benefit to creditors than the [debtors] have shown here."); Wellman v. Wellman, 933 F.2d 215, 218 (4th Cir. 1991), *cert. denied*, 502 U.S. 925 (1991) (holding that there is no benefit to the estate "when the result is to benefit only the debtor rather than the estate"); Adelphia Recovery Trust v. Bank of Am., N.A., 390 B.R. 80, 94 (S.D.N.Y. 2008), *aff 'd*, 379 Fed. App'x 10 (2d Cir. 2010), *cert. dismissed*, 131 S. Ct. 896 (2011) ("[I]t is well settled in the Second Circuit, that avoiding powers may be exercised by a debtor in possession only for the benefit of creditors, and not for the benefit of the debtor itself.") (citations omitted) (internal quotation marks omitted); Trans World Airlines, Inc. v. Travellers Int'l AG (*In re* Trans World Airlines, Inc.), 163 B.R. 964, 972 (Bankr. D. Del. 1994) ("[T]he Code clearly contemplates the use of avoidance action recoveries in the operation of the business in a manner which only indirectly benefits creditors.").

[575] Harstad v. First Am. Bank, 39 F.3d 898, 904–05 (8th Cir. 1994).

[576] *In re* Burlington Motor Holdings, Inc., 231 B.R. 874, 877 (Bankr. D. Del. 1999) ("[The] Plan does not delegate preference recoveries to the estate or list them as a source of funds designated to pay down the Note. Rather, any recovery of preferences in this case will benefit only the Successor Corporation.").

[577] *See* Harstad v. First Am. Bank, 39 F.3d 898, 904–05 (8th Cir. 1994); *In re* Burlington Motor Holdings, Inc., 231 B.R. 874, 877 (Bankr. D. Del. 1999).

Given those obstacles, the Commissioners discussed whether the federal notice standards as articulated by the U.S. Supreme Court in *Mullane v. Central Hanover Bank & Trust Co.* would suffice.[578] The *Mullane* standard basically requires notice by means "reasonably calculated, under all the circumstances, to apprise the interested parties of the pendency of the action, and afford them an opportunity to present their objections."[579] The Commission determined, however, that to the extent the trustee would be seeking to recover value from the subsequent transferees, actual notice should be required. Based on these considerations, the Commission recommended clarifying section 550 to permit the trustee to name a subsequent transferee as a defendant in the original, underlying cause of action and, if not named, to require the trustee to sue the subsequent transferee in a subsequent action, at which time the subsequent transferee should be permitted to assert defenses to the original avoidance cause of action.

The Commissioners then analyzed the extra-territorial application of the trustee's avoiding powers and recovery rights under section 550 to subsequent transferees. The Commissioners acknowledged the primary competing interests at stake: the perceived unfairness in permitting avoidance of transfers made to parties within the United States, but then precluding that remedy as to any subsequent transferees overseas; and the reasonable expectations of foreign transferees, particularly those who may not know that the transfer originated from the debtor, including the expectation that any payments they received were governed by the laws of their respective jurisdictions. The Commissioners methodically walked through examples when this issue may present itself. They considered situations were a feeder fund is the initial transferee and noted the relevance of the solvency of the feeder fund. They examined the facts of the *Madoff* and *Maxwell* cases and discussed the factual nuances of these cases.[580] The Commissioners acknowledged and appreciated the delicate balance required in these instances.

The Commissioners discussed how best to balance the competing interests with well-established principles of comity. The Commissioners generally agreed with the notion that foreign transfers should be subject to the chapter 5 avoiding powers, but only if such application was consistent with principles of comity. Accordingly, the Commission approved the recommendation that section 550 cover domestic or foreign subsequent transferees extra-territorially to the same extent as domestic subsequent transferees, but agreed that the court should consider whether allowing such action to proceed is consistent with general principles of comity and is reasonably necessary to protect the interests of the estate considering the expectations of the defendants, the laws of the foreign jurisdiction, and the relief available to the trustee in the foreign jurisdiction.

Once a trustee identifies potential avoidance and recovery actions under chapter 5 of the Bankruptcy Code, courts have differed on whether the trustee may pursue those actions if recoveries will go to stakeholders other than general unsecured creditors. The Commissioners discussed the origins of the concept that avoidance action recoveries

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[578] Mullane v. Central Hanover Bank & Trust Co., 339 U.S. 306, 314 (1950).

[579] *Id.*

[580] *See, e.g., In re* Maxwell Commc'n Corp., 93 F.3d 1036, 1047–48 (2d Cir. 1996); Sec. Investor Prot. Corp. v. Bernard L. Madoff Inv. Sec. LLC, 2014 U.S. Dist. LEXIS 91508 (S.D.N.Y. July 6, 2014).

should inure only to the benefit of general unsecured creditors and whether such a limited purpose aligned with the concept of the estate.[581] The Commissioners discussed witness testimony that supported limiting the beneficiaries of preference actions to unsecured creditors. They also considered whether administrative claimants or old equity should be permitted to benefit from recoveries under section 550. The Commissioners drew on the facts and holding in *Mirant Corp.*, in which the Fifth Circuit interpreted section 550(a) and found that "[a] bankruptcy trustee may still have standing to avoid a fraudulent transfer after the unsecured creditors are satisfied in full."[582]

The Commissioners found the reasoning of courts following a broader interpretation of section 550(a) to be sound and consistent with the general concept of the bankruptcy estate. The estate does not represent only general unsecured creditors in a case, but often represents a variety of stakeholders whose interests also may have been harmed by improper transfers and transactions subject to avoidance under chapter 5 of the Bankruptcy Code. The Commission voted to endorse a broad interpretation of the term "for benefit of the estate" in section 550(a) to mean all parties with claims against, or interests in, the estate, including administrative claimants and old equity but not including claims of post-petition secured creditors. In reaching this conclusion, however, the Commission agreed that this principle only affected a trustee's action for recoveries against transferees under section 550; it did not expand or otherwise affect a trustee's underlying cause of action under section 544, 545, 547, 548, 549, or 553(b).

D. Labor and Benefits

1. Collective Bargaining Agreements Under Section 1113

Recommended Principles:

- Disputes regarding modification and rejection of a company's collective bargaining agreements can be time-consuming, expensive, and litigious. These disputes also can be emotionally charged and disruptive at key points in the chapter 11 process. Moreover, and perhaps most importantly, they involve a resource many consider critical to a company's successful restructuring — its employees. Accordingly, the Bankruptcy Code should be amended to further the objectives of negotiation and consensual resolution underlying the collective bargaining process and section 1113.
- To that end, section 1113 should be amended to add requirements that, in addition to the provisions of section 1113(b)(1), the trustee should: (i) provide notice to the applicable labor organization(s) that modifications to the collective bargaining agreement are being proposed along with an initial proposal and description of the information to be made available for the labor organization to evaluate the proposal; and (ii) file a notice of intent to initiate

[581] *See, e.g.*, Mellon Bank NA v. Dick Corp., 351 F.3d 290, 293 (7th Cir. 2003), *cert. denied*, 541 U.S. 1037 (2004) (explaining that section 550 "speaks of benefit to the estate — which in bankruptcy parlance denotes the set of all potentially interested parties").

[582] MC Asset Recovery LLC v. Commerzbank A.G. (*In re* Mirant Corp.), 675 F.3d 530, 534 (5th Cir. 2012).

proceedings under section 1113(b) and schedule an initial conference with the court regarding such proceedings. The foregoing is intended to promote transparency, disclosure, and communication among the parties, and to provide a reasonable time to conduct negotiations in an effort to reach a consensual agreement prior to the commencement of any litigation by the trustee to reject the collective bargaining agreement. Accordingly, section 1113 should be amended as follows:

- The trustee should file a request for an initial conference regarding the initiation of section 1113 proceedings with the court and serve the request on the authorized representative of the affected employees (the "authorized representative") and any other party entitled to notice of matters pending in the case under the Bankruptcy Rules. In the request, the trustee should certify that it has provided the authorized representative with a written copy of its initial proposal and the other information required by section 1113(b)(1).
- The court should set a status conference to discuss the process with the trustee and the authorized representative. This conference should be scheduled so as to allow the authorized representative sufficient time to (i) review the trustee's notice, initial proposal, and proposed information disclosures; and (ii) meet and confer with the trustee to discuss a timetable for conducting negotiations, any information-related matters, and any other particulars relevant to the conduct of negotiations, including whether the parties believe a mediator would assist in their discussions. The court should conduct the initial conference on or before 30 days after the filing of the trustee's request for an initial conference.
- At the initial conference, the trustee and the authorized representative should be prepared to: (i) discuss the timetable for conducting negotiations over the proposal; (ii) resolve any initial issues regarding the disclosure of information relevant for the evaluation of the proposal; (iii) identify any issues regarding the resources available to the parties so that they may engage in informed discussions regarding the request for modifications; (iv) discuss whether the participation of a mediator would assist the parties; and (v) discuss any other issues that may present obstacles to conducting informed, good faith negotiations regarding the trustee's request for modifications. The court may also wish to establish an expedited process for the resolution of any information-related disputes.
- If, following a reasonable period of time and consistent with the timetable established at the initial conference (which should take into consideration the nature and scope of the modification proposal), the parties have not reached an agreement regarding mutually acceptable modifications, the trustee may request a further status conference in order for the parties to report to the court regarding the status of the process and for the trustee to request a case management process for a motion to reject the collective bargaining agreement. At such status conference, the court should set a date by which the trustee and the authorized representative

would submit a case management and scheduling order. The proposed hearing schedule may incorporate a bifurcation of the trial into an initial hearing schedule for the presentation of the trustee's case and then, following an adjournment, a second hearing schedule for the authorized representative to present its case. The scheduling order may provide for the (continued) participation of a mediator to facilitate discussions between the parties if requested by the parties or otherwise warranted under the circumstances. The court should schedule the start of the trial on the motion to reject the collective bargaining agreement on or before 180 days after the filing of the trustee's request for an initial conference, unless the trustee and the authorized representative agree to extend, or the court for cause extends, this deadline. The parties should factor this trial deadline into the timetable established at the initial conference.

o Statutory committees should be able to attend and observe any status conferences conducted under this principle, but participation, including at any hearing on rejection, should be limited to receiving and reviewing information from the trustee and the authorized representative and evaluating the trustee's business judgment regarding the decision to seek rejection under section 1113. Statutory committees would also be heard in the usual manner in connection with any settlement reached between the trustee and the authorized representative.

o The foregoing recommendations should not be read to, and are not intended to, alter current law with respect to section 1113(e).

• The trustee's rejection of a collective bargaining agreement under section 1113 should be treated as a breach of such agreement. The authorized representative may assert a claim for monetary damages arising from the rejection of the collective bargaining agreement against the estate, on behalf of the affected employees, which claim should be a general unsecured claim, if the rejection order occurs prior to assumption of the agreement, similar to the assertion of rejection damages claims by counterparties to contracts rejected under section 365 pursuant to sections 365(g) and 502(g). Any such rejection damages claims should be determined in accordance with applicable nonbankruptcy law for breach of contract and subject to mitigation.

a. Collective Bargaining Agreements Under Section 1113: Background

The U.S. Supreme Court's decision in *N.L.R.B. v. Bildisco* resolved disparate rulings among the lower courts regarding the treatment of collective bargaining agreements in bankruptcy.[583] In *Bildisco*, the Supreme Court reaffirmed the characterization of a collective bargaining agreement as an executory contract subject to rejection under section 365 of the Bankruptcy Code.[584] The Supreme Court also held

[583] N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513 (1984), *superseded by statute*, Public Law 98-353 (section 1113 of the Bankruptcy Code), *as recognized in* N.L.R.B. v. Manley Truck Line, Inc., 779 F.2d 1327, 1331 n. 7 (7th Cir. 1985).

[584] *Id.* at 522–23.

that, in recognition of the "special nature" of a collective bargaining agreement, the debtor in possession's[585] proposed rejection of a collective bargaining agreement was subject to a "somewhat stricter standard" of review than the generally applicable business judgment standard.[586] The Court rejected a very strict standard proposed by the National Labor Relations Board, which was adopted by the Second Circuit in *REA Express*,[587] i.e., that the debtor in possession should not be permitted to reject a collective bargaining agreement unless it can show that rejection is necessary to prevent the liquidation of the debtor. Instead, the Court endorsed a standard that it viewed as "somewhat higher than that of the 'business judgment rule' but a lesser one than that embodied in the *REA Express* opinion."[588] The Court also held that a debtor in possession's unilateral modification of a collective bargaining agreement prior to court approval of the rejection was not an unfair labor practice in violation of the National Labor Relations Act (the "NLRA").[589]

Congress enacted section 1113 of the Bankruptcy Code in direct response to the *Bildisco* decision.[590] Section 1113 establishes particularized rules regarding the treatment of collective bargaining agreements when an employer is in chapter 11.[591] Among other things, section 1113 establishes special procedures and standards that are applicable when a debtor in possession seeks to modify, or ultimately reject, a collective bargaining agreement. The statute prescribes a process of bargaining between the debtor in possession and the authorized representative of the affected employees as a prerequisite to seeking court-approved rejection. In the absence of an agreed-upon resolution regarding the debtor in possession's proposed modifications, the debtor in

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[585] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[586] *Id.* at 524 ("We agree with these Courts of Appeals that because of the special nature of a collective-bargaining contract, and the consequent 'law of the shop' which it creates, [citation omitted] a somewhat stricter standard should govern the decision of the Bankruptcy Court to allow rejection of a collective-bargaining agreement.").

[587] Bhd. of Ry., Airline & Steamship Clerks v. REA Express, 523 F.2d 164 (2d Cir. 1975).

[588] *See id.* at 525 (holding that bankruptcy court should permit rejection if "the debtor can show that the collective bargaining agreement burdens the estate, and that, after careful scrutiny, the equities balance in favor of rejecting the collective bargaining agreement"). The standard adopted by the Supreme Court drew upon the rejection standard proposed by the Eleventh Circuit in *In re* Brada Miller Freight Sys., Inc., 702 F.2d 890 (11th Cir. 1983).

[589] *Id.* at 532–33. The Supreme Court's rationale was that a collective bargaining agreement, like other executory contracts, was not enforceable by the nondebtor party upon the debtor's bankruptcy filing. The Court's ruling meant that, where an employer in chapter 11 committed an unfair labor practice by unilaterally modifying a collective bargaining agreement on filing for bankruptcy, statutory remedies under labor law would be unavailing. *See* 29 U.S.C. § 158(a)(5) (providing that it shall be an unfair labor practice for an employer "to refuse to bargain collectively" with the employees' authorized representative); *id.* § 158 (d) (establishing the parties' mutual obligation to bargain collectively, including, among other things, "that no party to [a labor contract] may terminate or modify such contract" absent compliance with the statute's requirements).

[590] *See In re* AMR Corp., 477 B.R. 384, 405–06 (Bankr. S.D.N.Y. 2012) (relating enactment of section 1113 in response to *Bildisco*). *See also* Andrew B. Dawson, *Collective Bargaining Agreements in Corporate Reorganizations*," 84 Am. Bankr. L.J., 103, 104 (2010) (same).

[591] Section 1113 applies to collective bargaining agreements covered by the National Labor Relations Act, 2 U.S.C. §§ 151–169 (the "***NLRA***") and to agreements covered by Title II of the Railway Labor Act, 45 U.S.C. §§ 181–188, which is applicable to the airline industry. Railroad collective bargaining agreements covered by Title I of the Railway Labor Act, 45 U.S.C. §§ 151–165, are subject to section 1167 of the Bankruptcy Code. *See* 11 U.S.C. § 1167.

possession may seek court-approved rejection. In doing so, the debtor in possession must meet the rejection standards set forth in the statute in order to obtain court approval, including demonstrating compliance with the statutory bargaining requirements.[592]

Thus, prior to seeking rejection, a debtor in possession must make a proposal to the authorized representative of the employees that provides relevant information necessary to evaluate the proposal, and meet and confer in good faith with the authorized representative in an attempt to reach a mutually acceptable modification to the labor contract.[593] When the parties' efforts do not result in a mutually acceptable modification to the collective bargaining agreement, the debtor in possession may seek court-approved rejection. Under section 1113, the filing of the debtor in possession's motion to reject the collective bargaining agreement requires the court to hold a hearing within 14 days after the filing date, upon at least 10 days' notice to the authorized representative, although the court may extend the time for commencement of the hearing for seven days or for additional periods of time when the debtor in possession and the authorized representative agree.[594]

The statute also sets out the standards for approval of a motion to reject a collective bargaining agreement. Under section 1113(c), the court may approve the motion to reject if the court determines that: (i) the debtor in possession complied with the statutory requirements attendant to making its proposal; (ii) the authorized representative refused to accept the debtor in possession's proposal "without good cause"; and (iii) "the balance of the equities clearly favors rejection."[595] In evaluating the "balance of the equities" standard, courts have articulated certain factors to be considered.[596] Section 1113 requires that the court enter a ruling on the motion to reject within 30 days of the date of the commencement of the hearing, unless the parties

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[592] In addition to the rejection requirements, and to counteract the Supreme Court's ruling in *Bildisco* that unilateral modification of a collective bargaining agreement prior to court-approved rejection does not constitute an unfair labor practice, Congress amended section 1113 to prohibits the trustee from unilaterally altering or terminating any provision of a collective bargaining agreement "prior to compliance with the provisions of [section 1113]." 11 U.S.C. § 1113(f). *See* Shugrue v. Air Line Pilots Ass'n, Int'l (*In re* Ionosphere Clubs, Inc.), 922 F.2d 984, 990 (2d Cir. 1990), *cert. denied*, 502 U.S. 808 (1991) (reviewing section 1113(f) and concluding that "Congress intended that collective bargaining agreement remain in effect. . . after the filing of a bankruptcy petition unless and until the debtor complies with the provisions of § 1113"). *See also In re* Cont'l Airlines, 125 F.3d 120, 137 (3d Cir. 1997), *cert. denied*, 522 U.S. 1114 (1998) (finding that the "intent behind section 1113 is to preclude debtors or trustees in bankruptcy from unilaterally terminating, altering or modifying the terms of a collective bargaining agreement without following its strict mandate").

[593] *See In re* Pinnacle Airlines Corp., 483 B.R. 381, 404–05 (Bankr. S.D.N.Y. 2012) (describing general operation of section 1113). The particular requirements regarding the proposal, provision of information, and good faith negotiations are set forth in section 1113(b)(1)(A) (standards for proposal), section 1113(b)(1)(B) (requirement to provide "relevant information as is necessary to evaluate the proposal"), section 1113(b)(2) (requirement that trustee meet with authorized representative and "confer in good faith in attempting to reach mutually satisfactory modifications"). 11 U.S.C. § 1113(b).

[594] *See* 11 U.S.C. § 1113(d)(1). Section 1113 requires the court to rule on a section 1113 motion to reject within 30 days of the date of the commencement of the hearing, unless the parties consent to an extension of this period. 11 U.S.C. § 1113(d)(2).

[595] *Id.* § 1113(c). The debtor bears the burden of proof on the elements of a section 1113 motion to reject. *See* Truck Drivers Local 807 v. Carey Transp. Inc., 816 F.2d 82, 88 (2d Cir. 1987).

[596] *See e.g.*, Truck Drivers Local 807 v. Carey Transp. Inc., 816 F.2d 82, 93 (2d Cir. 1987) (detailing six factors to be considered in evaluating the balance of the equities).

consent to an extension of this period.[597] Although an early division in the interpretation of the rejection standard occurred when the Second and Third Circuits issued divergent rulings on the application of the "necessary" and "fair and equitable" standards applicable to the debtor in possession's proposal under section 1113(b)(1),[598] a study by Professor Andrew Dawson suggests that the difference in interpretation has not appeared to impact the courts' ultimate rulings — courts have generally approved the debtor in possession's motion to reject under section 1113(c).[599]

b. Collective Bargaining Agreements Under Section 1113: Recommendations and Findings

For debtors with a unionized workforce, the treatment of their labor contracts may represent one of the most important and difficult decisions in the chapter 11 case.[600] These contracts represent the company's obligations to its employees and are an integral component of the company's relationship with its employees. These contracts, however, also may impose monetary obligations on the company that it no longer can sustain in light of financial distress and its need to reorganize.[601] The Commission appreciated fully the crucial considerations and potentially dynamic elements in the collective bargaining process in a chapter 11 case. In particular, the Commissioners noted that labor relations following rejection should be taken into consideration in utilizing section 1113: even if a collective bargaining agreement is ultimately rejected

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[597] In addition to the procedures set forth in section 1113(b) through (d), section 1113 also provides for emergency "interim relief " whereby a court may authorize a debtor to make interim changes to wages, benefits, or work rules under the collective bargaining agreement "if essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate." 11 U.S.C. § 1113(e). *See* Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC, 791 F.2d 1074, 1088 (3d Cir. 1986) (explaining that, in enacting section 1113, "Congress recognized that there might be immediate problems of an emergency nature in individual cases" and therefore provided for "interim changes" if the court finds "that an interim change is 'essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate'") (citations omitted). *See also* 7 Collier on Bankruptcy ¶ 1113.02[3] (describing interim relief provision and "high standards" generally applied to requests for such relief); *In re* Salt Creek Freightways, 46 B.R. 347, 349–50 (Bankr. D. Wy. 1985) (explaining enactment of section 1113(e)).

[598] *See* 11 U.S.C. § 1113(b)(1)(A). *Compare* Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC, 791 F.2d 1074, 1088–89 (3d Cir. 1986) *with* Truck Drivers Local 807 v. Carey Transp. Inc., 816 F.2d 82, 89 (2d Cir. 1987).

[599] *See, e.g.*, Dawson, *supra* note 590, at 104 (collecting data on how courts interpret the factor that the proposal be "necessary to the reorganization of the debtor" and concluding that "[b]ased on data from every large publicly traded company bankruptcy between 2001 and 2007, the present study reveals that the outcome of [section] 1113 motions was the same regardless of the legal standard applied: the court granted the debtor's motion to reject its CBA").

[600] *Oral Testimony of the Honorable Stephen S. Mitchell: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13–14 (Mar. 14, 2013) (ASM Transcript) ("I have to say at the outset that I thought that the decisions I had to make in terms of termination of pension plan or termination of retiree benefits or modification of a collective bargaining agreement or proving interim changes to a collective bargaining agreement were some of the toughest I've had to make as a judge . . . I could tell you in no other matters that have come before me in 16 years on the bench that I receive so much mail in chambers and they were profoundly affecting. I mean, I fully understood that for some people it means they themselves might end up having to file up for bankruptcy because necessary financial support was being taken away from them."), *available at* Commission website, *supra* note 55.

[601] *Written Statement of Michael Robbins: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Mar. 14, 2013) (acknowledging that there is a need for labor representatives to make meaningful economic concessions for employers to survive), *available at* Commission website, *supra* note 55.

through the section 1113 process, the company remains obligated to continue to bargain with the authorized representative over modifications to the agreement.[602]

Most of the testimony received by the Commission on section 1113 issues concerned the bargaining process itself and the deadlines imposed by this section.[603] Witnesses expressed concern that the statutory requirements did not, in practice, foster meaningful negotiations.[604] Rather, some witnesses suggested that many debtors in possession viewed the bargaining required under the Bankruptcy Code as a means to the litigated end they desired.[605] The Honorable Stephen Mitchell of the U.S. Bankruptcy Court for the Eastern District of Virginia (whose cases included the *US Airways* bankruptcy cases) also testified that the statutory deadlines simply did not work, particularly the 14-day hearing requirement.[606]

The Commission considered whether refinements to the statutory process would better serve the goals of the statute. Section 1113(b)(2) provides: "During the period beginning on the date of the making of a proposal provided for in paragraph (1) and ending on the date of the hearing provided for in subsection (d)(1), the trustee shall meet, at reasonable times, with the authorized representative to confer in good faith in attempting to reach mutually satisfactory modifications of such agreement." Thus, with respect to the bargaining process, section 1113 does not provide any minimum period

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[602] *See e.g.*, N.L.R.B. v. Bildisco & Bildisco, 465 U.S. 513, 534 (1984), *superseded by statute*, Public Law 98-353 (section 1113 of the Bankruptcy Code), *as recognized in* N.L.R.B. v. Manley Truck Line, Inc., 779 F.2d 1327, 1331 n. 7 (7th Cir. 1985) (noting that debtor in possession remains obligated to bargain collectively with labor organization following formal approval of rejection).

[603] *Written Statement of Michael Robbins: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Mar. 14, 2013) ("[T]he expedited schedule mandated under Section 111 creates tremendous downward pressure on wages and working conditions. . . . [T]he 1113 process has become in practice a rushed 51-day countdown to destruction of their agreements."), *available at* Commission website, *supra* note 55.

[604] *See Oral Statement of Bob Keach: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Mar. 14, 2013) (ASM Transcript) ("The predominance of Section 363 sales of substantially all the assets of debtors means that often the purchaser do not assume collective bargaining agreements or pension liabilities. This has particularly challenged the statutory regime for addressing such agreements and liabilities."), *available at* Commission website, *supra* note 55; *Oral Testimony of Robert Roach Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 51 (Mar. 14, 2013) (ASM Transcript) ("In normal contract negotiations there's give and take, there's talking and there's a result at the end of it. . . . When you bargain on 1113 after a period of time, and it's two weeks and a week after they file, it's either you accept what the company gives you or you don't have a collective bargaining agreement."), *available at* Commission website, *supra* note 55. "Negotiation is you come in with a position and both sides are compromised. There is no need for the corporation to compromise in the chapter 1113 proceeding." *Id.* at 58.

[605] *See Oral Testimony of Debora Sutor: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 42–45 (Mar. 14, 2013) (ASM Transcript) ("Bankruptcy should only be used as a last resort. Instead . . . companies . . . are routinely placed in bankruptcy soles as a means to escape obligations and reward top executives and middle managers for simply executing a bankruptcy plan."), *available at* Commission website, *supra* note 55; *Oral Testimony of James Campbell Little: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 35 (Mar. 14, 2013) (ASM Transcript) (stating that the debtor (company) essentially had a gun to labor's head — it was a take it or leave it proposition, not a negotiation), *available at* Commission website, *supra* note 55.

[606] *Oral Testimony of the Honorable Stephen S. Mitchell: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13–17 (Mar. 14, 2013) (ASM Transcript) ("Section 1113 and 1114 relief actually require that the judge hold a hearing within 14 days. . . . In reality there were no 14-day hearings or even 21-day hearings in the matters that came in front of me. Everybody understood that there had to be a certain amount of discovery, we [review] the underlying financials, there are opportunities to depose each side's experts and things like that."), *available at* Commission website, *supra* note 55.

during which the parties must engage in good faith bargaining.[607] A debtor in possession could, consistent with the statute, serve a proposal and then, subject only to the requirements of proof set forth in section 1113(c), file a rejection motion quite soon thereafter. The motion would then be subject to the statutory hearing and notice schedule.

Courts and commentators have emphasized that an important goal of section 1113 is to encourage negotiated resolutions when a debtor in possession seeks modifications to its collective bargaining agreements and when litigation should be a last resort.[608] And, as one court has explained, the amount of time to be allowed for negotiations "must depend on the facts and circumstances of each case."[609]

The Commissioners discussed these perspectives and whether the requirements currently provided in section 1113(b) were sufficient to generate a meaningful dialogue between the debtor in possession and the authorized representative. The Commissioners generally agreed that the effectiveness of section 1113 was case dependent, but some suggested the process could be improved by more clearly separating the bargaining and the litigation processes. These Commissioners noted that the current process often placed the bargaining and the potential litigation on parallel tracks that had the parties trying to reach a compromise while the debtor in possession was preparing its case to support, and the authorized representative was working to identify good cause to block, the rejection of the agreement. These Commissioners also agreed with the witness testimony that bargaining under section 1113 could be shallow and perceived as a formality in the process.[610] Other Commissioners disagreed with this

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[607] *See, e.g.*, *Oral Testimony of Robert Roach, Jr., ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 25 (Mar. 14, 2013) (ASM Transcript) (stating that the current good faith negotiation requirement in section 1113 "is not adequate because negotiating in good faith just means coming to the table and talking, it doesn't mean give or take. . . . [There may be] back and forth, but . . . no negotiation"), *available at* Commission website, *supra* note 55.

[608] *E.g.*, N.Y. Typographical Union No. 6 v. Maxwell Newspapers, Inc. (*In re* Maxwell Newspapers, Inc.), 981 F.2d 85, 90 (2d Cir. 1992) (explaining that the statute's "entire thrust" is to "ensure that well-informed and good faith negotiations occur in the market place, not as part of the judicial process"); Dawson, *supra* note 590, at 119 (noting that the statutory "text clearly indicates that Congress preferred the outcome of negotiated settlements to labor disputes"). *See also In re* Century Brass Prods., Inc., 795 F.2d 265, 273 (2d Cir. 1986), *cert. denied*, 479 U.S. 949 (1986) (finding that section 1113 "encourages the collective bargaining process as a means of solving a debtor's financial problems insofar as they affect its union employees"); *In re* Hostess Brands, Inc., 477 B.R. 378, 382 (Bankr. S.D.N.Y. 2012) (["Section 1113's] unique purpose is . . . to provide for expedited, good faith bargaining and, ultimately, a determination by the court, if that doesn't occur."); Richard H. Gibson, *The New Law on Rejection of Collective Bargaining Agreements in Chapter 11: An Analysis of 11 U.S.C. § 1113*, 58 Am Bankr. L. J. 325, 327 (1984) (reviewing the statute and legislative history and describing principal purpose to "discourage both unilateral action by the debtor and recourse to the bankruptcy court"). "Instead, the law seeks to encourage solution of the problem through collective bargaining." *Id.*

[609] Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC, 791 F.2d 1074, 1093–94 (3d Cir. 1986) (noting that the need for haste, in and of itself, is not a determining factor, citing the interim relief provision under section 1113(e) which is available to address emergency situations).

[610] *Oral Testimony of Robert Roach, Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 58 (Mar. 14, 2013) (ASM Transcript), *available at* Commission website, *supra* note 55; *Oral Testimony of Debora Sutor: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 42–45 (Mar. 14, 2013) (ASM Transcript), *available at* Commission website, *supra* note 55; *Oral Testimony of James Campbell Little: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 35 (Mar. 14, 2013) (ASM Transcript), *available at* Commission website, *supra* note 55.

characterization of the process, but acknowledged the benefit to all parties of a more effective and efficient process.

The Commissioners then analyzed improving the current framework under section 1113. They recognized the delicate balance between encouraging meaningful negotiations and allowing the debtor in possession to move to litigation when necessary. To evaluate potential reforms to the section 1113 process, the Commissioners reviewed practices that have been employed in many chapter 11 cases, in which the parties opted for case management procedures in lieu of the statutory scheduling requirements, and have identified certain "best practices" from these cases. Their discussion focused on the realities of chapter 11 practice — as suggested by Professor Dawson's study, the debtor in possession usually can prevail on the motion to reject, but that result typically is not in the best interests of the debtor or its employees. Rather, a consensual resolution typically is in the best interests of both parties; it can avoid potential ill will between the parties, lost production for the debtor, and hardship for its employees.

The Commissioners proposed a more structured process for exchanging information and establishing the parameters of bargaining. The Commissioners debated whether the court should be involved in the process from the outset. The Commission determined that requiring an initial status conference with the court would encourage meaningful disclosures and discussions earlier in the process. In this context, it also considered the mandatory appointment of a mediator to help the parties reach a potential resolution more quickly. The Commissioners perceived value in the mediator's role, but expressed concerns regarding costs and a one-size-fits-all approach to a mediator. They believed that a mediator likely would be an asset in many cases, but believed it would be a more effective tool if invoked based on the facts of the particular case.[611]

Under the principles adopted by the Commission, there would be an initial conference that would follow disclosure of the proposal by the debtor in possession to the authorized representative and a notice to parties in the case of the debtor in possession's intention to seek modifications to a collective bargaining agreement by commencing a section 1113 process. The Commission determined that, at an initial conference with the court, the parties should discuss their bargaining timeline, any issues regarding disclosures made by the debtor in possession regarding its proposal, and any potential barriers to meaningful, good faith negotiations. It did not believe that the statute should establish specific deadlines for negotiations. Instead, it wanted the parties and the court to have flexibility under the general guidance that the bargaining parties have reasonable time to engage in meaningful, good-faith negotiations.

The Commissioners also discussed an appropriate trigger for permitting a debtor in possession to proceed to litigation to reject the agreement. They compared a trigger similar to one proposed by labor-backed legislation (i.e., the NLRA standard), based upon standards under nonbankruptcy labor law requiring an employer to bargain to

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[611] *Oral Testimony of Robert Roach, Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 60 (Mar. 14, 2013) (ASM Transcript) (stating that whether a mediator would be helpful depends on the circumstances of the case), *available at* Commission website, *supra* note 55; *Oral Testimony of James Campbell Little, Jr.: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 60 (Mar. 14, 2013) (ASM Transcript) (noting that mediators are not a panacea and that the utility of a mediator will vary by case, by mediator, etc.), *available at* Commission website, *supra* note 55.

"impasse" prior to unilateral implementation,[612] and the alternative of imposing an outside deadline based only on the passage of time. Although the Commissioners understood labor's preference for the NLRA standard, many of the Commissioners believed that the debtor in possession needed certainty as to when the case could move forward if a consensual resolution was not forthcoming. These Commissioners noted that the impasse standard could stall a debtor in possession's restructuring efforts indefinitely to the detriment of the debtor in possession and its other stakeholders (and arguably the employees as well). After considering various triggers, the Commission voted to recommend that the procedures incorporate an outside date for the start of the trial on the debtor in possession's motion to reject within 180 days of the debtor in possession's request for an initial conference. The Commissioners noted specifically that the forgoing recommended principles regarding the new case management procedures applied only when a debtor in possession pursued relief under section 1113(b), (c), or (d), and that the principles were not intended to change the current law under section 1113(e) applicable to a debtor in possession's request for interim, emergency relief.

In developing the principles for the enhanced case management process, the Commission also considered whether and to what extent other parties in interest should participate in the section 1113 proceedings.[613] For example, some of the Commissioners suggested that a statutory unsecured creditors' committee should be permitted to participate in the process. Others noted that the committee is not a party to the agreement and raised concerns about introducing third parties into the negotiation process.[614] The Commission settled on the approach used in the *Delphi* chapter 11 case, where, in ruling on a motion to limit participation in the section 1113 proceedings, the court determined that certain parties, including the statutory unsecured creditors' committee, could participate in the section 1113 process solely with respect to asserting a position regarding the debtor in possession's business judgment in seeking section 1113 relief and not with respect to whether the section 1113 factors had been met.[615] The Commission found persuasive the *Delphi* court's distinction between the role of the statutory committee in fulfilling its due diligence obligations regarding the debtor in possession's business judgment to pursue the rejection motion, as a non-ordinary course action by the debtor in possession, and the particulars of the bargaining process and

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[612] *See The Protecting Employees and Retirees in Business Bankruptcies Act of 2013*, H.R. 100, 113th Cong. § 102 (1st sess. 2013) (proposing that a debtor may file a motion to reject a collective bargaining agreement, if, after a period of negotiations, the debtor and labor representative have not reached agreement on modifications "and further negotiations are not likely to produce mutually satisfactory modifications"). *See also N.L.R.B. v. Bildisco & Bildisco*, 465 U.S. 513, 533 (1984) (describing "impasse" requirement under the NLRA).

[613] *See* 11 U.S.C. § 1113(d)(1) (providing that, at a hearing on the motion to reject a collective bargaining agreement, "[a]ll interested parties may appear and be heard at such hearing"). The Seventh Circuit has held that section 1113(d)(2) limits the participants— the parties who are authorized to modify the agreement (and any guarantor of the agreement) — to the debtor and the applicable bargaining representative(s) of the affected employees. *In re* UAL Corp., 408 F.3d 847 (7th Cir. 2005).

[614] *See, e.g., Oral Testimony of David R. Jury: ACB Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 23 (Mar. 14, 2013) (ASM Transcript) ("Collective bargaining is a relationship that in most cases long predated the filing of the petition and if the parties are successful will continue long after the bankruptcy case closes. On the other hand, creditor's committees [are transient]. It came into existence with the case, it will go out of existence with the end of the case."), *available at* Commission website, *supra* note 55.

[615] *In re* Delphi Corp., Case No. 05-44481 (Bankr. S.D.N.Y. May 9, 2006) (oral decision).

related section 1113 factors, which are matters that should be left to the debtor in possession and the authorized representative both in terms of their negotiations and litigation regarding the debtor in possession's proposal and related bargaining.

The Commission also considered the consequences of the rejection of a collective bargaining agreement; specifically, does rejection give rise to a rejection damages claim, and if so, how should the claim be determined? The Commissioners discussed the current split in the case law regarding rejection damages under section 1113. One court decision, *In re Blue Diamond Coal Co.*, held that rejection damages were unavailable under section 1113 as a matter of statutory construction.[616] The *Blue Diamond* court's view was that section 1113 completely removed collective bargaining agreements from the provisions of section 365 of the Bankruptcy Code.[617] Other courts have disagreed with the *Blue Diamond* analysis of section 1113 and its relationship to section 365 and other provisions of the Bankruptcy Code, and instead have interpreted sections 1113 and 365 as working in tandem, thus permitting the assertion of rejection damages claims for the rejection of collective bargaining agreements under section 1113. As one court has explained, "[s]ection 1113 is designed to provide additional procedural requirements for rejection or modification of collective bargaining agreements, and only to that degree supersedes and supplements the provisions in § 365."[618]

The Commissioners also noted the discussion by the court in *Northwest Airlines*.[619] In this decision, the court labeled the effect of rejection as an "abrogation" of the agreement rather than a breach of the agreement, thus calling into question whether an order granting rejection could give rise to a claim for rejection damages. The Commissioners were persuaded by the reasoning and results of courts interpreting section 1113 as supplementary to section 365, as well as the practicalities of the availability of a rejection damages claim in reaching a resolution. The Commission voted to recommend that section 1113 be amended to clarify that rejection of a collective bargaining agreement constitutes a breach of the agreement as of the time of rejection, and that a claim for rejection damages may be asserted. The Commissioners also discussed how such claims would be determined. First, the Commission determined that, like damages claims asserted by nondebtor parties to contracts rejected under section 365, such claims would be general unsecured claims where rejection occurs prior to assumption of a collective bargaining agreement.[620] In addition, the

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[616] *In re* Blue Diamond Coal Co., 147 B.R. 720 (Bankr. E.D. Tenn. 1992), *aff 'd*, 160 B.R. 574 (E.D. Tenn. 1993).

[617] *See* Michael St. Patrick Baxter, *Is There a Claim For Damages from the Rejection of a Collective Bargaining Agreement Under Section 1113 of the Bankruptcy Code?*, 12 Bankr. Dev. J. 703 (1996) (reviewing *Blue Diamond* decision).

[618] Mass. Air Conditioning & Heating Corp. v. McCoy, 196 B.R. 659, 663 (D. Mass. 1996) (citing Norfolk and Western Railway Co. v. Am. Train Dispatchers Ass'n, 499 U.S. 117, 136 n. 2 (1991) (Stevens, J., dissenting)). *See also In re* Moline Corp., 144 B.R. 75, 78 (Bankr. N.D. Ill. 1992) (ruling that section 365 operates to fill in the gap left in section 1113 regarding rejection damages and that such omission was a legislative error); Baxter, *supra* note 617 (concluding that section 365 continues to apply except to the extent inconsistent with section 1113 and that section 365(g) applies to permit a claim for rejection damages).

[619] Nw. Airlines Corp. v. Ass'n of Flight Attendants (*In re* Nw. Airlines Corp.), 483 F.3d 160 (2d Cir. 2007).

[620] The allocation of a rejection damages among affected employees generally is handled in the context of the proof of claim filed by the authorized representative, but different procedures have been applied depending on the circumstances. *See In re* U.S. Truck Co., Inc., 89 B.R. 618 (E.D. Mich. 1988) (basing allocation on union's proof of

Commission agreed that, generally, such claims would be based on the difference between the reductions implemented following rejection and the collective bargaining agreement terms prior to rejection, akin to a breach of contract claim under federal labor law, noting specifically that to the extent actual mitigation of damages by particular employees would apply to such claims, such mitigation would similarly apply to a rejection damages claim.[621]

2. Retiree Benefits and Section 1114

Recommended Principles:

- The trustee should comply with the requirements of section 1114 of the Bankruptcy Code for all retiree benefits (as defined in section 1114(a)), even if the trustee contends that such benefits are terminable at will under the terms of the benefit plan or applicable nonbankruptcy law. The trustee's compliance with section 1114 for benefits that the trustee contends may be terminable at will should not create any new claims on behalf of retirees or otherwise affect the existence, nature, or scope of any retirees' claims upon the termination or modification of such benefits in accordance with section 1114, which claims should be determined consistent with the terms of the plan or applicable nonbankruptcy law.

a. Retiree Benefits and Section 1114: Background

Section 1114 requires the debtor in possession[622] to timely pay any retiree benefits and to follow a notice, disclosure, and bargaining process before seeking to modify any retiree benefits during the chapter 11 case. It also provides administrative priority for payments of retiree benefits required to be made before the effective date of a confirmed plan.[623] The protections afforded retiree benefits under section 1114 are supplemented by a corresponding plan confirmation requirement under section 1129(a)(13). Section 1114 defines the term "retiree benefits" as "payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise) maintained or established in

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claim). The Commission's recommendation on rejection damages under section 1113 does not affect these various approaches to allocation.

[621] *See id.* at 625 (overruling objections to union claim for rejection damages and, where employer based need for rejection on ability to continue operation of the business, allowing union's claim to be calculated as the difference between reductions in compensatory terms and other monetary terms implemented post-rejection and terms under nonrejected collective bargaining agreement, based on analogy to claim under federal labor law for unilateral breach of collective bargaining agreement).

[622] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[623] 11 U.S.C. § 1114(e).

whole or in part by the debtor prior to filing a petition commencing a case under this title."[624]

With respect to the modification of retiree benefits, the section 1114 process resembles the section 1113 process for the rejection of collective bargaining agreements, with at least one key difference.[625] Under section 1114, a committee authorized by the court to serve as an "authorized representative" of such retirees will represent retirees who are receiving benefits not covered by a collective bargaining agreement in the section 1114 process.[626]

As suggested above, the term "retiree benefits" is broad and covers such payments under any pre-petition "plan, fund, or program (through the purchase of insurance or otherwise) maintained or established" by the debtor. In fact, some courts interpret this language to include payments under a pre-petition retiree benefit plan even if the debtor contends that it has expressly reserved the right to unilaterally terminate or modify such plan at any time.[627] For example, in *Visteon*, the relevant plan documents provided that "the Company reserves the right to suspend, modify or amend the benefits provided under the Plan, or even terminate the Plan or any of the benefits provided under the Plan. . . . [T]his handbook is not a contract, nor is it a guarantee of your coverage."[628] The Third Circuit adopted a strict reading of the statute and determined that "[t]he fact that the debtor could have unilaterally stopped the payments had it not been in chapter 11 is . . . irrelevant."[629] Nevertheless, other courts have ruled that a debtor in possession is not required to comply with the section 1114 process when the debtor in possession establishes that it has the right under the pre-petition program of benefits to unilaterally modify or terminate the benefits.[630]

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[624] 11 U.S.C. § 1114(a).

[625] *See In re* Farmland Indus., Inc., 294 B.R. 903, 918 (Bankr. W.D. Mo. 2003) ("A consideration of § 1113 of the [Bankruptcy] Code provides further support for the Court's understanding of § 1114.").

[626] 11 U.S.C. § 1114(b)(1), (2), (d). The union under the collective bargaining agreement that gave rise to the retiree benefits presumptively serves as the authorized representative for retirees receiving such benefits. 11 U.S.C. § 1114(c).

[627] *See, e.g.*, IUE-CWA v. Visteon Corp. (*In re* Visteon Corp.), 612 F.3d 210, 219–20 (3d Cir. 2010) ("Section 1114 could hardly be any clearer. It restricts a debtor's ability to modify *any* payments to *any* entity or person under *any* plan, fund, or program in existence when the debtor files for Chapter 11 bankruptcy, and it does so notwithstanding any other provision of the [B] ankruptcy [C]ode."); *In re* Farmland Indus., Inc., 294 B.R. 903, 914 (Bankr. W.D. Mo. 2003) ("In this court's view, §1114 prohibits a debtor from terminating or modifying any retiree benefits (as defined in that section) during a Chapter 11 case unless the debtor complies with the procedures and requirements of §1114, regardless of whether the debtor has a right to unilaterally terminate benefits."). *See also* IUE-CWA v. Visteon Corp. (*In re* Visteon Corp.), 612 F.3d 210, 227 (3d Cir. 2010) (explaining legislative history indicating a desire to protect "the 'legitimate expectations' of retirees, and the necessity in a 'just society' of giving effect to those expectations wherever possible"); S. Rep. No. 100-119, at 1–2 (1987), *reprinted in* 1988 U.S.C.C.A.N. 683, 684 ("[T]o provide additional protections for the insurance benefits of retirees, their spouses and dependents, of debtors under the Bankruptcy Code").

[628] IUE-CWA v. Visteon Corp. (*In re* Visteon Corp.), 612 F.3d 210, 213 (3d Cir. 2010).

[629] *Id.* at 222.

[630] *See, e.g.*, *In re* Gen. Motors Corp., No. 09-50026, Hr'g Tr. at 109:24-110:2 (Bankr. S.D.N.Y. June 25, 2009) ("Section 1114 doesn't apply to employee benefit plans that are terminable or amendable unilaterally by the plan sponsor."); *In re* Delphi Corp., 2009 WL 637259, at *19 (S.D.N.Y. Mar. 11, 2009) ("[I]f, in fact, the debtors have the unilateral right to modify a health or welfare plan . . . the debtors' pre-Bankruptcy rights [are not] abrogated by the requirements of section 1114."); *In re* N. Am. Royalties, Inc., 276 B.R. 860 (Bankr. E.D. Tenn. 2002); Retired W. Union Employees Ass'n v. New Valley Corp. (*In re* New Valley Corp.), 1993 WL 818245 (D.N.J. Jan. 28, 1993); *In re* Doskocil Cos. Inc., 130 B.R. 870 (Bankr. D. Kan. 1991).

b. Retiree Benefits and Section 1114: Recommendations and Findings

Bankruptcy Code sections 1114 and 1129(a)(13) evidence a strong policy preference for protecting the rights of retirees in a debtor in possession's chapter 11 case. Section 1114 was enacted in response to the *LTV Steel Company* chapter 11 case in which the debtor in possession announced its intention to discontinue health benefits for approximately 70,000 retired employees immediately upon the petition date on the basis that such benefits would be considered pre-petition claims.[631] The Commissioners understood the history behind section 1114 and the special protections afforded retirees under the Bankruptcy Code. They also observed that retiree issues, when present in a chapter 11 case, can create complex and challenging issues for the debtor in possession.

The Commissioners discussed the current split in the case law regarding whether the section 1114 procedures apply to all pre-petition retiree benefit plans, including those that were found to be terminable at will by the debtor outside of bankruptcy. The Commissioners acknowledged the plain meaning interpretation of section 1114 endorsed by the Third Circuit in *Visteon*. They discussed the focus of this decision on the application of section 1114 during the pendency of the chapter 11 case. As the Third Circuit explained in discussing the treatment of retiree benefits under a chapter 11 plan, "the duration of the period the debtor has obligated itself to provide such benefits plainly encompasses any durational obligations, including those arising outside of the bankruptcy context."[632] Accordingly, even if bound by the section 1114 process during the chapter 11 case, the reorganized debtor could exercise any applicable contractual or nonbankruptcy law rights after the bankruptcy. The Commissioners also noted certain procedural advantages provided by the statute, including the designation of a statutory authorized representative for retirees to engage in the process.

The Commissioners weighed the *Visteon* approach against several competing considerations. For example, courts finding that certain retiree benefit plans fall outside the scope of section 1114 and rely heavily on the parties' pre-petition nonbankruptcy rights. Some commentators have noted the practical appeal to this approach given that, even under *Visteon*, the debtor in possession presumably could pay retiree benefits during the case and then, as a reorganized debtor, terminate or modify those benefits immediately after the case, provided that the pre-petition benefit plan was found to support a reservation of that right for the company as plan sponsor.

The Commissioners also factored into their deliberations the significant complexity of conducting "at will" litigation over the scope of section 1114 during bankruptcy and the time and expense consumed by such litigation. They evaluated the utility of this litigation to the chapter 11 case. The Commissioners generally found nominal value in the litigation because section 1114 is a process based provision. Any such changes could occur only if the parties agreed to them through the section 1114 negotiation process or the court authorized the modifications proposed by the debtor in possession after the required negotiations.

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[631] *See In re* Chateaugay Corp., 64 B.R. 990, 992 (S.D.N.Y. 1986); 133 Cong. Rec. H8558 (daily ed. Oct. 13, 1987) ("[T]he triggering event for [enacting § 1114] was [the] bankruptcy of LTV Steel. . . .").

[632] IUE-CWA v. Visteon Corp. (*In re* Visteon Corp.), 612 F.3d 210, 224 (3d Cir. 2010) (citations omitted) (internal quotation marks omitted).

Moreover, the Commissioners discussed the purpose and value of the process itself. The steps required by section 1114 provide retirees with representation and a seat at the negotiation table during the chapter 11 case. The process not only gives retirees a voice, but it also ensures that any changes proposed or made by the debtor in possession to retiree benefits are not precipitous and are understood by all affected parties. The Commissioners found value in the process for both the debtor in possession and retirees in cases in which the debtor in possession believed some change to retiree benefits was necessary — regardless of whether the debtor could implement such change unilaterally outside of bankruptcy.

In light of the various relevant factors, the Commission determined that requiring a debtor in possession to follow the section 1114 process for any proposed change to, or termination of, any retiree benefits was the better approach. In reaching this conclusion, however, the Commission also agreed that the debtor in possession's initiation of the section 1114 process where the debtor could have asserted a unilateral right to modify or terminate outside of bankruptcy should not create new claims or otherwise change the claims currently provided under the statute. Accordingly, if the parties agreed to, or the court approved, a change to, or termination of, retiree benefits through the section 1114 process, a debtor in possession asserting an "at will" or other defense limiting its obligations under the pre-petition plan could assert such defense in objecting to the amount of any claims asserted by the retirees or their authorized representative arising from the termination or modification of the benefit plan through the section 1114 process. Likewise, the respective rights and remedies of the reorganized debtor and retirees under the pre-petition plan (unless such obligations were altered by agreement as part of the 1114 negotiation process) would continue following the debtor's emergence from chapter 11.

E. Administrative Claims

1. Section 503(b)(9) and Reclamation

Recommended Principles:

- The protections afforded by section 503(b)(9) of the Bankruptcy Code should be limited to the value of goods received by, or at the direction of, the debtor in the ordinary course of business within 20 days before the commencement of the case. Section 503(b)(9) should be amended accordingly to permit creditors providing goods on a drop shipment basis to assert appropriate claims under this section.
- A creditor should be required to file a proof of claim and appropriate supporting documentation for any claims it may hold against the estate under section 503(b)(9) on or before the applicable bar date unless otherwise provided by an order of the court. Any such proof of claim should specifically identify the amount of the claim that the creditor asserts is subject to section 503(b)(9). A creditor's failure to file a timely proof of claim should constitute a waiver of such claim unless otherwise provided by an order of the court.
- A party's rights under section 503(b)(9) should replace any rights or remedies that the party may have under applicable nonbankruptcy law based

upon reclamation or similar doctrines. Accordingly, section 546(c) should be amended accordingly.

a. Section 503(b)(9) and Reclamation: Background

Section 503(b)(9) of the Bankruptcy Code provides administrative claim treatment to trade creditors for "the value of any goods received by the debtor within 20 days before the date of commencement of a case under this title in which the goods have been sold to the debtor in the ordinary course of business."[633] The BAPCPA Amendments added this section to the Bankruptcy Code. "The legislative history surrounding this section is scant, but presumably Congress was concerned about providing a vehicle to enhance payment to creditors who shipped goods to a debtor in the ordinary course of business on the eve of bankruptcy."[634]

Under section 503(b)(9), trade creditors selling goods (but not providing services) to the debtor during the immediate pre-petition period receive an administrative priority claim for the value of those goods that remains unpaid on the petition date, regardless of whether the seller satisfies the requirements for reclamation. Prior to the BAPCPA Amendments, the entirety of a trade creditor's claims were treated as general unsecured claims, unless such creditor could establish a valid reclamation claim under Section 2-702 of the Uniform Commercial Code and section 546 of the Bankruptcy Code. To establish a reclamation claim, a creditor was required to, among other things, send its reclamation demand within 10 days after the buyer received the goods.

The BAPCPA Amendments implemented two key changes. First, they elevated certain of a trade creditor's claims to administrative priority under section 503(b)(9). Second, they extended the reclamation reachback period to 45 days and, if the 45-day period had not expired when the bankruptcy petition was filed, granted the creditor an additional 20 days from the commencement of the bankruptcy case to send its written reclamation demand. Although the second change appeared favorable to trade creditors in theory, it has turned out, in practice, to be often illusory. Section 546(c) also states that reclamation rights are expressly subject to the prior rights of a creditor with a security interest in the goods, largely reaffirming prior case law.[635]

Accordingly, as a practical matter, trade creditors seek to protect a portion of their pre-petition claims under section 503(b)(9) and rarely pursue their reclamation rights under state law and section 546(c). One issue that frequently arises in this context is the process trade creditors must follow to preserve their administrative claim under section 503(b)(9). Section 503(b) states that allowance of a claim under that section is subject to notice and a hearing. This may require a creditor asserting a section 503(b)(9) claim to retain counsel and to file a motion because there is no Bankruptcy Code provision or Bankruptcy Rule permitting creditors to assert their section 503(b)(9) claims by filing a proof of claim. In certain cases, in order to simplify the process of asserting section

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[633] 11 U.S.C. § 503(b)(9).

[634] Judith Greenstone Miller & Jay L. Welford, *503(b)(9) Claimants — The New Constituent, a/k/a "The 500 Pound Gorilla," At The Table*, 5 Depaul Bus. & Com. 487 (2007).

[635] *See, e.g., In re* Furrs Supermarkets, Inc., 2012 WL 3396146, at * 3 (Bankr. D.N.M. 2012); *In re* Circuit City Stores, Inc., 441 B.R. 496, 508–10 (Bankr. E.D. Va. 2010); *In re* Advanced Marketing Servs., Inc., 360 B.R. 421, 427 (Bankr. D. Del. 2007); *In re* Dana Corp., 367 B.R. 409, 419 (Bankr. S.D.N.Y. 2007).

503(b)(9) claims and to minimize the costs of addressing those claims, debtors have moved for approval of, and courts have approved, procedures that have either authorized the modification of the official proof of claim form (the "Official Form") to include a specific reference to section 503(b)(9) claims or authorized the filing of a separate proof of claim to assert the section 503(b)(9) claim.

Although section 503(b)(9) has provided additional protections to trade creditors who supply goods to the debtor, certain aspects of section 503(b)(9) are ambiguous. The ambiguities include: (i) what constitutes "goods,"[636] (ii) how is the "value" of goods determined,[637] (iii) when goods have been "received,"[638] (iv) whether section 503(b)(9) claims should be disallowed or be subject to setoff when a preference or other claim is asserted against the subject creditor,[639] and (v) when should section 503(b)(9) claims be paid (on the effective date or sometime earlier).[640] Both creditors and the estate are affected by these issues and frequently incur litigation costs to try to resolve the uncertainty.

b. Section 503(b)(9) and Reclamation: Recommendations and Findings

The Commission received conflicting testimony concerning the administrative priority of trade claims for certain goods under section 503(b)(9). Some witnesses testified that this additional class of administrative claims made it more difficult for

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[636] *In re* NE Opco, Inc., 2013 WL 5880660 (Bankr. D. Del. Nov. 1, 2013) (holding that electricity provided by municipal lighting plant was a service not a good, but natural gas provided by the same plant was a good); *In re* S. Mont. Elec. Generation & Transmission Coop., Inc., 2013 WL 85162 (Bankr. D. Mont. Jan. 8, 2013) (holding that electricity was a good where debtor was not an end user, but only a wholesaler of electricity); GFI Wis., Inc. v. Reedsburg Util. Comm'n, 440 B.R. 791 (W.D. Wis. 2010) (holding that electricity is a good where debtor was not an end user of electricity); *In re* Erving Indus., Inc., 432 B.R. 354 (Bankr. D. Mass. 2010) (holding that electricity is a good, not a service); *In re* Plastech Engineered Prods., Inc., 397 B.R. 828 (Bankr. E.D. Mich. 2008) (natural gas is a good). *But cf. In re* Pilgrim's Pride Corp., 421 B.R. 231 (Bankr. N.D. Tex. 2009) (holding that natural gas and water are goods subject to section 503(b)(9), but where debtor is the end user of electricity, electricity is not a good but rather a service, and thus is not subject to section 503(b)(9)); *In re* Samaritan Alliance, LLC, 2008 WL 2520107 (Bankr. E.D. Ky. June 20, 2008) (holding that electricity is better characterized as a service, not a good).

[637] *In re* S. Mont. Elec. Generation & Transmission Coop., Inc., 2013 WL 85162 (Bankr. D. Mont. 2013) (holding that invoice price is proper value of goods); *In re* SemCrude, L.P., 416 B.R. 399 (Bankr. D. Del. 2009) (same); *In re* Pilgrim's Pride Corp., 421 B.R. 231 (Bankr. N.D. Tex. 2009) (holding that replacement cost is the proper value of goods).

[638] *In re* Momenta, Inc., 455 B.R. 353 (Bankr. D.N.H. 2011) (addressing whether drop shipped goods were received by the debtor); *In re* Circuit City Stores, Inc., 432 B.R. 225 (Bankr. E.D. Va. 2010) (addressing when consigned goods were received by the debtor); *In re* Plastech Engineered Prods., Inc., 397 B.R. 828 (Bankr. E.D. Mich. 2008) (addressing whether drop shipped good were received by the debtor).

[639] *In re* Ames Dep't Stores, Inc., 582 F.3d 422 (2d Cir. 2009) (holding that section 502(d) is not a ground for disallowance of an administrative priority claim); *In re* Energy Conversion Devices, Inc., 486 B.R. 872 (Bankr. E.D. Mich. 2013) (same); *In re* Plastech Engineered Prods., Inc., 394 B.R. 147 (Bankr. E.D. Mich. 2008) (same). *See also In re* Momenta, Inc., 455 B.R. 353 (Bankr. D.N.H. 2011) (holding that section 502(d) is not a ground for disallowance of a section 503(b)(9) claim); *In re* TI Acquisition, LLC, 410 B.R. 742, (Bankr. N.D. Ga. 2009) (same). *But cf. In re* MicroAge, Inc., 291 B.R. 503 (B.A.P. 9th Cir. 2002) (holding that debtor could assert preference claim as basis for temporarily disallowing section 503(b)(9) priority claims); *In re* Circuit City Stores, Inc., 426 B.R. 560 (Bankr. E.D. Va. 2010) (same).

[640] *In re* Arts Dairy, LLC, 414 B.R. 219 (Bankr. N.D. Ohio 2009) (explaining that a debtor was not immediately required to pay a section 503(b)(9) claim); *In re* Global Home Prods., LLC, 2006 WL 3791955 (Bankr. D. Del. Dec. 21, 2006) (holding that section 503(b)(9) claim should be paid after confirmation of plan); *In re* Bookbinders' Rest., Inc., 2006 WL 3858020 (Bankr. E.D. Pa. Dec. 28, 2006) (holding that claimant was not entitled to immediate payment of section 503(b)(9) claim).

debtors to reorganize because the chapter 11 plan must pay these claims in full on the effective date under section 1129(a)(9).[641] This testimony was consistent with testimony provided to Congress on the topic of the *Circuit City* bankruptcy and similar retail chapter 11 cases.[642] Other witnesses strongly disputed that trade claims were an impediment to confirmable plans of reorganization.[643]

The Commissioners weighed this testimony with anecdotal evidence concerning the types of challenges faced by chapter 11 debtors, including retail debtors, since 2005.[644] For example, debtors are more highly leveraged.[645] As a result, they have less value available to support their reorganization efforts. The economic recession that started in 2008 affected several industries and accelerated or contributed to firms' financial distress. The BAPCPA Amendments also made other changes to the Bankruptcy Code that arguably altered chapter 11 practice, at least as compared to the pre-2005 period.[646]

The Commissioners acknowledged that trade creditors are aware of, and rely on, their rights under section 503(b)(9) in making pre-petition credit and shipment decisions. Some of the Commissioners raised concerns about the increasing number of

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[641] *Written Statement of John Collen, Partner, Tressler LLP: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 26, 2012) (stating that section 503(b)(9) puts huge demands on the cash of the debtor and undermines the debtor's reorganization), *available at* Commission website, *supra* note 55; *Written Statement of Dan Dooley, CEO of MorrisAnderson: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2013) (stating that section 503(b)(9) increases the cost of reorganization which in turn fuels trend toward bankruptcy alternatives), *available at* Commission website, *supra* note 55; *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 10 (Nov. 15, 2012) ("Because holders of administrative claims are not placed in classes and do not vote on a plan, and each administrative creditor must be paid in full in cash at the time of confirmation, unless that creditor agrees otherwise, §503(b)(9) creates holdout power in all members of a particular group of creditors, contrary to the policy of bankruptcy law to reduce such power. Because of that power, and the requirement to pay all administrative expenses even in sale cases, secured creditors will reserve for such claims, reducing the resources available to distressed debtors for reorganization.") (citations omitted), *available at* Commission website, *supra* note 55.

[642] *See Circuit City Unplugged: Why Did Chapter 11 Fail to Save 34,000 Jobs?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 111th Cong. 44 (2009) (statements of Harvey R. Miller and Richard M. Pachulski). *But see id.* (statement of Professor Todd J. Zywicki, George Mason School of Law) [hereinafter *Zywicki Statement*]; *Lehman Brothers, Sharper Image, Bennigan's and Beyond: Is Chapter 11 Bankruptcy Working?: Hearing Before the Subcomm. on Commercial and Administrative Law of the Comm. on the Judiciary*, 110th Cong. 21 (2008) (statement of Professor Barry E. Adler, Esq., New York University School of Law) [hereinafter *Adler Statement*].

[643] *See generally Transcript, NACM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (May 21, 2013), *available at* Commission website, *supra* note 55.

[644] *See, e.g.*, Bob Duffy, *Broken Beyond Repair: Is BAPCPA Unfairly Blamed for Rash Retail Liquidations*, J. of Corp. Renewal (Jan. 8, 2009); *Written Statement of Lawrence Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (June 4, 2013) (stating that BAPCPA deadlines are hurting retail debtors' chances of rehabilitation), *available at* Commission website, *supra* note 55.

[645] *See U.S. Retail Case Studies in Bankruptcy Enterprise Values and Creditor Recoveries*, Fitch Case Studies — Retail Edition 1–2 (Apr. 16, 2013) [hereinafter Fitch Report] (observing that there is a "tendency of distressed retailers to maximize secured borrowings, subordination of significant administrative claims and dilution of recoveries from pension, general unsecured trade and operating lease rejection claims placed downward pressure on unsecured recoveries") Analyzing a sample of 20 retail cases, the Fitch Report observed that in each case at least one first lien claim was paid in full, but, alternatively, the median unsecured claim recovery was less than 10 percent, while the average was 20 percent. *Id. See also* Stephen A. Donato & Thomas L. Kennedy, *Trends in DIP Financing: Not as Bad as It Seems?*, J. Corp. Renewal, Sept./Oct. 2009.

[646] *See* Section III.A, *Brief History of U.S. Business Reorganization Laws*.

administrative and priority claims categories.[647] Each additional administrative or priority claim category undercuts the Bankruptcy Code's policy of fair and pro rata distributions among similarly situated creditors. The Commission agreed that administrative and priority status should be a limited exception and that general unsecured status should be the rule. Several Commissioners did not believe, however, that eliminating the section 503(b)(9) category would provide significant benefits to the estate, but they did believe that it may make operating the debtor's pre-petition business more challenging or expensive to the extent that trade creditors refuse to ship goods or will do so only on modified credit or all-cash terms. On balance, the Commission voted to retain the section 503(b)(9) administrative claims priority, provided that this provision represent the only priority treatment made available to such creditors. The Commission also agreed to recommend the elimination of all reclamation rights in bankruptcy under section 546(c), as well as any doctrine of necessity arguments related to these claims.[648]

In making this determination, the Commissioners discussed whether a valid basis existed for excluding drop shipment transactions, when the trade creditor supplies goods on the debtor's behalf to another party, from section 503(b)(9). The Commissioners acknowledged the statutory support for the exclusion given that the debtor does not "receive" the goods in this instance and given that section 503(b)(9) was intended to benefit creditors with reclamation rights.[649] Nevertheless, they discussed the substance of drop shipment transactions and their use to increase efficiencies in the transactions, which may still be provided for the benefit of the debtor's business. Accordingly, the Commission determined that, if the debtor directed the creditor to ship the goods directly to a third party in lieu of the debtor making that shipment, then applying section 503(b)(9) serves the same policy goal of encouraging trade creditors to supply goods on credit and should apply to the drop shipment transaction.

The Commissioners also discussed the inclusion of services in section 503(b)(9). Again, the Commissioners recognized the difficulty in drawing a bright line to limit the scope of the exception to that necessary to achieve the desired policy goals. They distinguished service providers from suppliers of goods based on their respective state law rights and the use of section 503(b)(9) as a substitution for creditors' state law reclamation rights. They also believed that a debtor in possession would have adequate ability to justify and request authority to pay service providers critical to the business and reorganization efforts through the Commission's proposed codification of the doctrine of necessity, as explained above.[650]

The Commissioners did note the confusion and uncertainty regarding the process for creditors to assert and preserve section 503(b)(9) claims. Some of the Commissioners suggested that, just as with any other administrative claim request, the creditor should be required to file a motion and justify the request. Other

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[647] *See, e.g.*, Howard Delivery Serv. Inc. v. Zurich Am. Insur. Co., 547 U.S. 651, 655 (2006) (explaining that exceptions to general equality principle should be "clearly authorized by Congress" and strictly construed).

[648] *See* Section IV.D.1, *Prepetition Claims and the Doctrine of Necessity*.

[649] *See, e.g.*, Ningbo Chenglu Paper Prods. Mrf. Co., Ltd v. Momenta, Inc. (*In re* Momenta, Inc.), 2012 WL 3765171, at *4 (D.N.H. Aug. 29, 2012).

[650] *See* Section IV.D.1, *Prepetition Claims and the Doctrine of Necessity*.

Commissioners believed that such a requirement would add unnecessary cost to the process and would not be particularly efficient for either the debtor in possession or the estate in many cases. After discussing various alternatives, the Commission agreed that these principles should recommend a modification to section 503(b)(9), the Bankruptcy Rules, and the Official Form to require creditors asserting section 503(b)(9) claims to file a proof of claim for such claims on or before the general bar date or a specific section 503(b)(9) bar date established by the court.

2. Administrative Claims Committee

Recommended Principles:

- Neither the court nor the U.S. Trustee should be authorized to constitute an official committee of administrative claimants. Accordingly, a new provision should be added to section 1102 to clarify this point.

a. Administrative Claims Committee: Background

Section 1102 of the Bankruptcy Code currently mandates the appointment of a committee of creditors holding unsecured claims and allows the court to order the appointment of other committees of creditors or equity security holders "if necessary to assure adequate representation" of such creditors or equity security holders. In all instances, the members of the committee are vetted and appointed by the U.S. Trustee. As discussed in Section IV.A.4, *Statutory Committees*, committees generally provide a voice for unsecured creditors in the case, protect the rights and interests of unsecured creditors, and serve as a statutory watchdog or check on the debtor in possession.

Traditionally, unsecured creditors were viewed as one of the more vulnerable classes of stakeholders in a chapter 11 case. Many debtors had liquidity or other resources to pay their secured creditors and administrative and priority claimholders, but often did not generate sufficient value to pay unsecured creditors in full, or even a meaningful distribution, in the case. Moreover, the Bankruptcy Code requires a debtor to pay the allowed claims of secured creditors and holders of administrative claims in order to confirm a chapter 11 plan. Accordingly, secured creditors and the holders of administrative claims typically have sufficient protection in a chapter 11 case.

In recent years, the more vulnerable (or perceived vulnerable) classes of stakeholders in a chapter 11 case have moved up in a debtor's capital structure. The debtor often does not generate sufficient value to pay its administrative claimants. As "administratively insolvent" cases have become more common, some practitioners have questioned whether administrative claimants need representation through the committee structure. Most courts have rejected requests for the appointment of administrative claims committees. The one notable exception is *In re LTV Steel*.

b. Administrative Claims Committee: Recommendations and Findings

Committees serve oversight and representative functions that generally are lacking in the chapter 11 case. The latter is particularly important in the context of unsecured creditors and, in some cases, equity security holders whose distributions in the chapter

11 case are determined largely by the value of the estate, or value generated for the benefit of the estate during the case. The Bankruptcy Code does not require a minimum distribution to general unsecured creditors or equity security holders. Rather, plan confirmation standards require only that these parties receive at least as much as they would receive in a chapter 7 liquidation and that, to the extent they are impaired, no junior class receive a distribution.

The Commissioners did not perceive the same risks for administrative claimholders. Although the value generated in a case may prove inadequate and administrative claims may not be satisfied in full, the Bankruptcy Code incorporates protections for these claimholders at least in the confirmation context. In addition, the Commissioners noted that the recommended principles on section 363x sales propose extending similar protection to administrative claimholders in the context of sales of all or substantially all of a debtor's assets. Accordingly, the Commission determined that the additional time and expense often associated with statutory committees were not necessary or warranted with respect to administrative claims.

3. WARN Act Claims

Recommended Principles:

- When a plant closing, mass layoff, or other triggering event under the Worker Adjustment and Retraining Notification Act (the "WARN Act") occurs on or after the filing of the bankruptcy petition, claims for (or on behalf of) employees for damages under the WARN Act should be treated as administrative claims under section 503(b) of the Bankruptcy Code for the number of post-petition days comprising the violation, provided that the claims are otherwise entitled to protection under the WARN Act.

a. WARN Act Claims: Background

The Worker Adjustment and Retraining Notification Act (the "WARN Act")[651] requires covered employers to provide affected employees with at least 60 days' advance notice prior to effecting a plant closing or covered mass layoff. The WARN Act is intended to "provide[] protections to workers, their families and communities by requiring employers to provide notification 60 calendar days in advance of plant closings and mass layoffs. Advance notice provides workers and their families some transition time to adjust to the prospective loss of employment, to seek and obtain alternative jobs and, if necessary, to enter skill training or retraining that will allow these workers to successfully compete in the job market."[652] When the required notice is

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[651] 29 U.S.C. §§ 2101–2109.

[652] 20 C.F.R. § 639.1(a). *See In re* FF Acquisition Corp., 438 B.R. 886, 891 (Bankr. N.D. Miss. 2010), *aff 'd and appeal dismissed sub nom.* Angles v. Flexible Flyer Liquidating Trust, 471 B.R. 182 (N.D. Miss. 2012), *aff 'd sub nom. In re* Flexible Flyer Liquidating Trust, 511 Fed. App'x 369 (5th Cir. 2013). *See also* Hotel Employees & Rest. Employees Int'l Union Local 54 v. Elsinore Shore Assocs., 173 F.3d 175, 182 (3d Cir. 1999) (noting adoption of WARN Act "in response to the extensive worker dislocation that occurred in the 1970s and 1980s").

not given, employers may be liable for back pay and benefits for the period of the violation, up to a maximum of 60 days.[653]

There are statutory exceptions that, if established by the employer, would permit a notification period of fewer than 60 days. Under the "faltering company" exception, a company may provide fewer than 60 days' notice of a plant closing if, during the 60 days prior to shutdown, the company was "actively seeking capital or business, which, if obtained, would have enabled the employer to avoid or postpone the shutdown and the employer reasonably and in good faith believed that giving the notice required would have precluded the employer from obtaining the needed capital or business."[654] In addition, when a mass layoff or plant closing is caused by business circumstances that were "not reasonably foreseeable as of the time the notice would have been required," the notification period may be reduced.[655] Similarly, a natural disaster may reduce the notice period.[656] An employer relying one of the statutory bases for a reduction in the notice period must still provide "as much notice as is practicable."[657] Other defenses to WARN Act liability may apply as well.[658]

Employees aggrieved by a violation of the notice requirement, or their representatives,[659] may assert claims for back pay for "each day of the violation," and for benefits under an employee benefit plan.[660] Liability is calculated for the period of the violation, up to a maximum of 60 days. Certain reductions may apply, for example, for any wages paid by the employer for the period of the violation.[661]

Liability for WARN Act damages when the requisite notice was not given has been analogized to liability for severance pay in lieu of notice, when courts have viewed such pay to be earned in full upon the triggering event. Thus, courts have held that WARN Act damages give rise to a right to payment upon the occurrence of the event triggering the violation (i.e., the employment termination or mass layoff). Accordingly, the timing of the triggering event generally has determined the payment classification of the claim for bankruptcy purposes. When employment loss occurred pre-petition, due to a plant closing or mass layoff that is covered by the WARN Act, the WARN Act damages claim generally has been held to arise in full pre-petition, even if the termination occurred close in time to a bankruptcy filing such that a portion of the 60-day period

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[653] *In re* FF Acquisition Corp., 438 B.R. 886, 891 (Bankr. N.D. Miss. Oct. 26, 2010), *aff 'd and appeal dismissed sub nom.* Angles v. Flexible Flyer Liquidating Trust, 471 B.R. 182 (N.D. Miss. 2012), *aff 'd sub nom. In re* Flexible Flyer Liquidating Trust, 511 Fed. App'x 369 (5th Cir. 2013). *See also* 29 U.S.C. § 104(a)(1)(A)–(B).

[654] 29 U.S.C. § 2102(b)(1). *See* 20 C.F.R. § 639.9(a) (setting forth qualifying requirements for "faltering business" exception).

[655] 29 U.S.C. § 2102(b)(2). *See* 20 C.F.R. § 639.9(b)(2) (setting forth indicators where business circumstance may not be reasonably foreseeable).

[656] *See* 29 U.S.C. § 2102(b)(2)(B); 20 C.F.R. § 639.9(c).

[657] 29 U.S.C. § 2102(b)(3).

[658] *E.g.*, *id.* § 2104(a)(4) (providing that, in an action to recover damages, where an employer proves "reasonable grounds for believing that the act or omission was not a violation" of the statute, court may reduce the amount of the liability). *See also id.* § 2103 (listing exemptions where plant closing or mass layoff constitutes a strike or lockout, or closing relates to a temporary facility).

[659] *See* United Food & Commercial Workers Local 751 v. Brown Grp., Inc., 517 U.S. 544 (1996) (holding that union representing affected employees has standing under WARN Act to sue for damages on their behalf).

[660] *See* 29 U.S.C. § 2104(a)(1)(A)–(B).

[661] *See id.* § 2104(a)(1), (2).

covered by the notice requirement included time following the petition date.[662] When applicable, pre-petition WARN Act claims have been held to be subject to the wage priority.[663]

When the event triggering WARN Act liability occurs post-petition, courts have held that employees terminated post-petition have claims that accrue in full post-petition.[664] Thus, these cases hold that WARN Act claims based on a post-petition termination are entitled to administrative priority.[665]

One case held differently, although in the context of deciding whether a WARN Act claim should proceed as an adversary proceeding or through the claims adjudication process. In *In re Circuit City*, the plaintiff was terminated post-petition, but the date on which notice should have been given, had his employer complied with the WARN Act, was eight days prior to the petition date.[666] The debtor argued that the claim arose on the date that notice was due, not on the date of termination. The court's rationale was that, as of the date the company gave notice of the store closing, which occurred prior to the bankruptcy, the employees had a "contingent" claim against the debtor, in the event the debtor's notice was inadequate under the WARN Act.[667] Thus, the court concluded

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[662] *See, e.g., In re* Powermate Holding Corp., 394 B.R. 765, 772–73 (Bankr. D. Del. 2008); Int'l Bhd. of Teamsters, AFL-CIO v. Kitty Hawk Int'l, Inc. (*In re* Kitty Hawk, Inc.), 255 B.R. 428, 438 (Bankr. N.D. Tex. 2000). *See also In re* First Magnus Fin. Corp., 403 B.R. 659, 665–66 (D. Ariz. 2009) (holding that WARN Act rights of workers discharged without requisite notice accrue in their entirety upon termination and damages are vested prepetition); *In re* Continentalafa Dispensing Co., 403 B.R. 653, 658 (Bankr. E.D. Mo. 2009) ("Here, Plaintiff was terminated before Debtors filed their petitions and therefore, Plaintiff performed no work after the petitions were filed. Thus, Plaintiff has a prepetition claim.").

[663] *E.g., In re* Powermate Holding Corp., 394 B.R. 765, 772–73 (Bankr. D. Del. 2008); Int'l Bhd. of Teamsters, AFL-CIO v. Kitty Hawk Int'l, Inc. (*In re* Kitty Hawk, Inc.), 255 B.R. 428, 438 (Bankr. N.D. Tex. 2000). Courts generally have held that WARN Act damages are considered "wages." *E.g., In re* Powermate Holding Corp., 394 B.R. 765, 771 (Bankr. D. Del. 2008); *In re* Hanlin Grp., Inc., 176 B.R. 329, 333 (Bankr. D.N.J. 1995); *In re* Riker Indus., Inc., 151 B.R. 823 (Bankr. N.D. Ohio 1993); *In re* Cargo, Inc., 138 B.R. 923, 927 (Bankr. N.D. Iowa 1992).

[664] Courts have considered whether to apportion WARN Act damages between prepetition and post-petition periods under section 503(b)(1)(a)(A)(ii), a section added to the Bankruptcy Code pursuant to BAPCPA. However, although courts have consistently declined to apply revised section 503(b) where a WARN Act event occurs prepetition, they have not agreed on an interpretation of this provision that would encompass WARN Act damages. *Compare In re* First Magnus Fin. Corp., 390 B.R. 667, 679 (Bankr. D. Ariz. 2008) (interpreting section 503(b)(1)(a)(A)(i) and (ii) such that both subparts must apply for subpart (ii) to apply at all, so that statute is inapplicable where no services are rendered post-petition), *with In re* Continentalafa Dispensing Co., 403 B.R. 653, 658 (Bankr. E.D. Mo. 2009) (holding that BACPA was not meant to "slant" the law to cover prepetition terminations), *and In re* Powermate Holding Corp., 394 B.R. 765, 777 (Bankr. D. Del. 2008) (holding that statutory use of "and" meant that subparts (i) and (ii) were independent examples of administrative claims, but BAPCPA was not meant to "drastically change the outcome of prepetition employment terminations"). *But see In re* Phila. Newspapers, LLC, 433 B.R. 164, 174–75 (Bankr. E.D. Pa. 2010) (disagreeing with *Powermate*'s conclusion that statute must be applied based on the timing of accrual or vesting of right to payment, but holding that statute is inapplicable to back pay award based upon contractual violation). The Commission did not address whether an employment loss resulting from a prepetition WARN Act triggering event could nonetheless fall within BAPCPA.

[665] *E.g., In re* Beverage Enters., Inc., 225 B.R. 111, 115–16 (Bankr. E.D. Pa. 1998) (holding that WARN Act claims of workers who were terminated approximately four months after chapter 11 petition was filed were deemed "severance" benefits that was earned immediately upon termination, that it was indisputable that termination occurred post-petition, and that WARN Act claims were therefore entitled to administrative priority); *In re* Hanlin Grp., Inc., 176 B.R. 329, 334 (Bankr. D.N.J. 1995) ("Back pay under WARN [Act] is deemed to be earned at the date of termination. Because the date of termination occurred post-petition, any back pay due for a WARN [Act] violation will be deemed as earned post-petition, and therefore in the nature of wages for services rendered after the commencement of the case entitled to administrative priority status.").

[666] *In re* Circuit City Stores, Inc., 2010 WL 120014 (Bankr. E.D. Va. Jan. 7, 2010).

[667] *Id.* at *4.

that (at least for purposes of determining the mechanism for pursing the claim) the claim arose on the date notice was due. The court thus concluded that the claim should proceed through the claims adjudication process and dismissed the plaintiff 's adversary proceeding.

b. WARN Act Claims: Recommendations and Findings

In considering cases involving post-petition closures or other triggering events under the WARN Act, the Commission agreed that the event giving rise to WARN Act damages is the loss of employment due to the WARN Act triggering event, and not the date the notice should have been given. In order to violate the WARN Act, an employer must effect a mass layoff or plant closing that takes place without providing the requisite WARN Act notice. Until such an event occurs, there has been no violation of the WARN Act. Thus, aggrieved employees should have a post-petition administrative claim for WARN Act damages for the number of post-petition days comprising the violation. The principle would apply assuming the claim for WARN Act damages is otherwise determined to be a valid claim under the WARN Act. The Commission did not address the substance of any potential defenses that may be applicable under the WARN Act, and instead proposed its recommendation strictly on the basis that the appropriate forum has otherwise determined that damages were owed.

The Commission considered whether a bright-line rule that post-petition WARN Act violations give rise to administrative claims might create an incentive for companies with plants or operations that are of doubtful viability to close such plants or operations pre-petition rather than trying to turn them around post-petition and risk an administrative priority WARN Act claim if the turnaround effort fails. However, strategic decisions based solely on the economics of a potential WARN Act claim seem unlikely, particularly because most courts already determine payment priority status based on the timing of the triggering WARN Act event, and the Commission's clarifying recommendation would not represent a significant change in current law.

4. Severance Benefits

Recommended Principles:

- An employee's claim for post-petition severance benefits should be eligible for treatment as an administrative claim under section 503(b)(1)(A)(i) of the Bankruptcy Code.
- If an employee is terminated post-petition and entitled to severance benefits that are calculated based on length of service, the employee's claim against the estate for severance benefits should be bifurcated between the pre-petition and post-petition periods, such that the employee is permitted to assert (i) a pre-petition claim for severance benefits based on pre-petition service and (ii) a post-petition administrative claim for severance benefits based on post-petition service. Such an employee also should be permitted to assert a priority

claim for any qualifying portion of the pre-petition severance benefits claim under section 507.

a. Severance Benefits: Background

Severance benefits generally are described as payments due to an employee as a result of the termination of employment or some other significant adjustment to or change in the employee's employment circumstances.[668] In a chapter 11 case, a debtor may reduce its workforce because, for example, it is downsizing, restructuring its business operations, or liquidating. Employees impacted by these decisions may be covered by pre-petition severance plans. These plans may be based on (i) a fixed payment at termination in lieu of notice, or (ii) the terminated employee's length of service.[669]

The treatment of employees' severance benefits in the chapter 11 case is important to both the debtor and its employees. The primary issue in this respect is whether the severance benefits are treated as pre-petition unsecured claims or post-petition administrative claims. Section 503(b) of the Bankruptcy Code grants administrative priority to the "actual, necessary costs and expenses of preserving the estate."[670] These claims generally include costs associated with operating the debtor's business and administering the estate during the chapter 11 case. Section 503(b)(1)(A)(i) specifically identifies "wages, salaries, and commissions for services rendered after the commencement of the case" as administrative claims.[671] These claims are entitled to payment priority (i.e., paid before pre-petition unsecured claims are paid) and generally must be paid in full under the chapter 11 plan. Accordingly, the characterization of severance benefits can have significant consequences for the debtor and the terminated employees.

Although not specifically referenced in the statute, courts analyze the treatment of severance benefits under section 503(b)(1)(A)(i).[672] In general, courts tend to treat severance benefits as pre-petition or post-petition claims based on the type of severance plan at issue: if it is a lump sum payment plan in lieu of notice, courts treat the benefits as post-petition claims;[673] if it is a plan based on length of service, courts generally allocate the benefits between pre-petition and post-petition claims according to when the severance benefits were earned.[674] Notably, the Second Circuit has rejected the

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[668] 5 Collier on Bankruptcy ¶ 507.06[5](b) (16th ed. 2012).

[669] *See, e.g.*, Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks (*In re* Health Maint. Found.), 680 F.2d 619, 621 (9th Cir. 1982); Richard F. Broude, Reorganizations Under Chapter 11 of the Bankruptcy Code 6-12.3 (Law Journal Press, 2005).

[670] 11 U.S.C. § 503(b).

[671] *Id.* § 503(b)(1)(A)(i).

[672] *Id.* Before a debtor can provide or pay any insider of the debtor administrative priority severance pay, the debtor must satisfy the requirements of section 503(c)(2). *Id.* § 503(c). The Commission did not address the payment of severance or other compensation to insiders under section 503(c).

[673] 5 Collier on Bankruptcy ¶¶ 503.06[7](d), 507.06[5](b) (16th ed. 2012).

[674] *See, e.g.*, Preferred Carrier Servs. Va., Inc. v. Phones For All, Inc. (*In re* Phones For All, Inc.), 288 F.3d 730 (5th Cir. 2002); Bachman v. Commercial Fin. Servs., Inc. (*In re* Commercial Fin. Servs., Inc.), 246 F.3d 1291, 1294 (10th Cir. 2001); *In re* Roth Am., Inc., 975 F.2d 949 (3d Cir. 1992); Lines v. Sys. Bd. of Adjustment No. 94 Bhd. of Ry., Airline & Steamship Clerks (*In re* Health Maint. Found.), 680 F.2d 619, 621 (9th Cir. 1982); Cramer v. Mammoth Mart, Inc. (*In re* Mammoth Mart, Inc.), 536 F.2d 950 (1st Cir. 1976); *In re* Public Ledger, Inc., 161

allocation of severance benefits — even under plans based on length of service — finding that the purpose of severance benefits is to compensate the employees for termination, which is the event that should determine the treatment of claims in bankruptcy.[675] Courts in the Second Circuit thus treat all true severance benefits triggered by a post-petition termination as post-petition administrative claims. Moreover, in the context of section 507(a)(4) priority claims, the Fourth Circuit has determined that severance compensation was "earned" upon the employees' termination.[676]

b. Severance Benefits: Recommendations and Findings

The Commission considered two issues with respect to severance benefits in chapter 11: first, whether section 503(b)(1)(A)(i) should be amended to specifically reference severance benefits, in addition to "wages, salaries, and commissions for services rendered after the commencement of the case"; and second, whether the Bankruptcy Code should be amended to address the treatment of severance benefits relating to a post-petition termination or other triggering event. The Commission agreed that "severance benefits" should be added to section 503(b)(1)(A)(i) and largely viewed this change as a technical amendment. The Commissioners engaged in a more in-depth analysis of the treatment of severance benefits as pre-petition or post-petition claims.

The Commissioners discussed the underlying nature of severance benefits. Some of the Commissioners viewed severance benefits in all circumstances as compensation for the termination itself, not wages or compensation for services previously rendered. These Commissioners emphasized that severance benefits are intended to mitigate at least some of the hardship imposed upon employees by the termination of employment and the resulting loss of wages and benefits. They also observed that, even if a severance plan uses length of service to calculate the amount of the severance benefit, that reference is solely a calculation tool and does not necessarily speak to the nature or purpose of the benefit. Finally, these Commissioners highlighted the additional burden on more senior employees imposed by an allocation rule. These employees may have the majority of their severance benefits calculated based on a long pre-petition tenure with the debtor, arguably penalizing them for their loyalty and service to the debtor.

F.2d 762 (3d Cir. 1947); Rawson Food Servs., Inc. v. Creditors' Comm. (*In re* Rawson Food Servs., Inc.), 67 B.R. 351 (Bankr. M.D. Fla. 1986).

[675] Rodman v. Rinier (*In re* W.T. Grant Co.), 620 F.2d 319 (2d Cir. 1980), *superseded by statute* (Bankruptcy Code) *as recognized in In re* Hooker Investments, Inc, 145 B.R. 138 (Bankr. S.D. New York. 1992); Straus-Duparquet, Inc. v. Local Union No. 3, Int'l Bhd. of Elec. Workers, AFL-CIO (*In re* Straus-Duparquet, Inc.), 386 F.2d 649, 651 (2d Cir. 1967), *superseded by statute* (Bankruptcy Code) *as recognized in In re* Drexel Burnham Lambert Grp., Inc., 138 B.R. 687, 711 (Bankr. S.D.N.Y. 1992) *See also* Supplee v. Bethlehem Steel Corp. (*In re* Bethlehem Steel Corp.), 479 F.3d 167, 175 (2d Cir. 2007) ("The key inquiry is whether the payment is a new benefit earned at termination or instead an acceleration of benefits [which the employee accrued over time].").

[676] Matson v. Alarcon, 651 F.3d 404, 409 (4th Cir. 2011). The Fourth Circuit specifically highlighted the difference in language between section 503(b)(1)(A)(i) and section 507(a)(4), noting that the former — dealing with characterization of employee payments as administrative claims — expressly tied such claims to "services rendered after the commencement of the case." *Id.* Accordingly, the Fourth Circuit's decision may have limited application in the analysis of severance benefits arising from a post-petition termination.

Other Commissioners strongly believed that severance benefits calculated based on length of service should be deemed earned when such services were provided. This approach requires an allocation of the severance benefits between the pre-petition and post-petition periods. These Commissioners observed that many claims are bifurcated in this manner under the Bankruptcy Code, and they did not find justification for varying it in the employment context. They also emphasized that administrative claims must be grounded in value provided to the estate — whether to preserve or enhance the estate — and focused on the general purpose and language of section 503(b) of the Bankruptcy Code.

In vetting these issues, the Commission considered the U.S. Supreme Court's decision in *United States v. Quality Stores*.[677] In *Quality Stores*, the Supreme Court held that severance payments were wages for purposes of FICA, and provided guidance on how to characterize these types of payments. Specifically, the Supreme Court explained:

> [S]everance payments often vary, as they did here, according to the function and seniority of the particular employee who is terminated. For example, under both termination plans, Quality Stores employees were given severance payments based on job grade and management level. And under the second termination plan, nonofficer employees who had served at least two years with their company received more in severance pay than nonofficer employees who had not — a standard example of a company policy to reward employees for a greater length of good service and loyalty.
>
> In this respect severance payments are like many other benefits employers offer to employees above and beyond salary payments. Like health and retirement benefits, stock options, or merit-based bonuses, a competitive severance payment package can help attract talented employees. Here, the terminations leading to the severance payments were triggered by the employer's involuntary bankruptcy proceeding, a prospect against which employees may wish to protect themselves in an economy that is always subject to changing conditions.[678]

Some of the Commissioners asserted that the Supreme Court's holding in *Quality Stores* suggested that the characterization of severance benefits as payment either due upon termination or for services previously provided by an employee should be left to the courts to resolve on a case-by-case basis. The advisory committee recommended this approach as well. Other Commissioners did not necessarily disagree with this assessment, but argued that the Bankruptcy Code should still clarify the treatment of severance benefits if the court determines they are earned based upon length of service under the applicable severance plan. The Commission recommended that the

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[677] United States v. Quality Stores, Inc., 134 S. Ct. 1395 (2014).
[678] *Id.* at 1499.

Bankruptcy Code codify an allocation rule for severance benefits triggered post-petition and calculated based on length of service. For additional views on the recommended principles for severance benefits, see *Appendix G*.

F. General Valuation Standards

Recommended Principles:

- The court should continue to determine valuation issues based on the evidence presented by the parties. The Bankruptcy Code should not dictate the valuation methodology to be used by the court in resolving these issues. Accordingly, no change to existing law is suggested on this point.
- The court should be permitted to use a court-appointed expert and to rely on the hearing testimony of a court-appointed expert in addition to any expert offered by the parties to assist in determining valuation issues. Section 105 of the Bankruptcy Code and Rule 706 of the Federal Rules of Evidence permit the court to appoint valuation experts. Accordingly, no change to existing law is suggested on this point.

a. General Valuation Standards: Background

Valuation issues arise at various points in a chapter 11 case. Parties may need a valuation of the debtor's assets early in the case to resolve, for example, a secured creditor's request for adequate protection under section 361 or to assess a proposed sale of some or all of a debtor's assets under section 363. They may need to revisit valuation issues later in the case in connection with creditors' requests for relief from the automatic stay or confirmation of a chapter 11 plan. Indeed, the value of a debtor's assets impacts adequate protection requests, post-petition financing terms and collateral, the amount of secured creditors' allowed secured claims against the estate, distributions available to creditors in the case, the feasibility of a plan, and the application of the absolute priority rule in the plan cramdown context.[679] Nevertheless, the Bankruptcy Code does not address valuation issues directly in the chapter 11 context or mandate a particular methodology for valuing a debtor's assets.

Accordingly, courts generally determine the value of a debtor's assets, and resolve any related valuation disputes, based on the evidence presented by the parties at the hearing on the matter. This method, commonly referred to as "judicial valuation," introduces some uncertainty into the process, but it also allows courts to consider various valuation methodologies and to tailor the valuation to the facts and circumstances at hand. Parties may value the debtor's assets based on, among other factors, a balance sheet analysis, a discounted cash flow analysis, or market

[679] Section 506(a)(1) provides that a secured creditor's claim is secured to the extent of the value of its collateral and that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest." 11 U.S.C. § 506(a)(1). In addition, section 506(a)(2) provides more specific guidance in the case of an individual under chapter 7 or 13. *Id*. § 506(a)(2) (mandating valuation based on the replacement value of the property as of the petition date in individual chapter 7 and 13 cases).

comparables.[680] Parties typically introduce this evidence through expert testimony at the hearing, and courts weigh and consider this testimony and the other evidence in reaching their valuations. Empirical studies suggest that courts thoughtfully consider valuation disputes and do not simply resolve such matters by splitting the difference.[681]

In addition to relying on the parties' experts, courts also may appoint an expert to testify on valuation issues. Rule 706 of the Federal Rules of Evidence provides that "the court may appoint any expert that the parties agree on and any of its own choosing." In addition, the court may establish the expert's duties and compensation in the order of appointment. Court-appointed experts generally are subject to discovery and cross-examination. Moreover, some courts have invoked section 105 of the Bankruptcy Code and Rule 706 of the Federal Rules of Evidence to appoint "experts with teeth," in that the court-appointed expert served both as a valuation expert for the court and a mediator between the parties on the valuation issues.[682]

b. General Valuation Standards: Recommendations and Findings

In general, valuation is more art than science. Regardless of the valuation methodology, the results depend on a variety of factors, including timing, market conditions, assumptions, and appraisers.[683] As one court explained:

> [T]he valuation of an enterprise . . . is an exercise in educated guesswork. At worst it is not much more than crystal ball gazing. There are too many variables, too many moving pieces in the calculation of value . . . for the court to have great confidence that the result of the process will prove accurate in the future. Moreover, the court is constrained by the need to defer to experts and, in proper circumstances, to Debtors' management.[684]

The Commissioners discussed the uncertainty surrounding valuation generally and considered whether judicial valuation significantly enhanced this uncertainty. Such inherent uncertainty is recognized in the legislative history of the Bankruptcy Code,

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[680] *See* Bernard Trujillo, *Patterns in a Complex System: An Empirical Study of Valuation in Business Bankruptcy Cases*, 53 UCLA L. Rev. 356 (2005). In addition, parties may present testimony of a potential purchaser or prospective user of the property at issue; the contract method or rates agreed to by the parties, or general observations about market or industry trends for such property. *Id.* at 383–85.

[681] *Compare id.* at 370 (study of 180 observations drawn from 145 published opinions reported in the Westlaw computer database decided from 1979 through 1998, finding "complete success for the debtor or for the creditor — about equally . . . [C]ourts very rarely split the difference between the debtor's and the creditor's numbers") *with* Keith Sharfman, *Judicial Valuation Behavior: Some Evidence from Bankruptcy*, 32 Fla. St. U. L. Rev. 387, 396 (2005) (study of 24 valuation disputes, finding "(1) bankruptcy judges on average allocated 65.2% of the value in controversy to debtors and only 34.8% to secured creditors; and (2) bankruptcy judges were more than three times as likely to allocate most of the value in controversy to debtors as they were to secured creditors"). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[682] *See, e.g.*, *In re* Calpine Corp., 377 B.R. 808 (Bankr. S.D.N.Y. 2007).

[683] *See, e.g.*, Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1941–42 (2006) ("A business, however, cannot be valued with such precision. There are different methods of valuing a business, but in the end all are merely estimates of the present value of the business's future earning capacity.").

[684] *In re* Mirant Corp., 334 B.R. 800, 848 (Bankr. N.D. Tex. 2005).

which explains that, "[a]s Peter Coogan has aptly noted, such a valuation [of the enterprise in connection with applying the absolute priority rule] is usually 'a guess compounded by an estimate'."[685] The Commission reviewed valuation methodologies used as part of, or independent from, judicial valuation to value a debtor's assets or business as a going concern. These methodologies include discounted cash flow, market comparables, and securities based valuations, among others. The Commissioners explored how different components of these valuation methodologies are subject to varying interpretation or application, which can cause fluctuation in asset or business valuations.[686] For example, an empirical study of companies emerging from chapter 11 prior to 1994 finds "that estimates of value are generally unbiased, but the estimated values are not very precise — the sample ratio of estimated value to market value varies from below 20 percent to more than 250 percent."[687] The authors of this study suggest that the variance in valuations may result from the administrative bankruptcy process or from strategic distortion. "The strategic distortion explanation for the imprecision of the cash flow forecasts implies that the valuation errors are systematically related to proxies for the competing financial interests and relative bargaining strengths of the parties."[688]

The Commissioners also examined the impact of valuation uncertainty on chapter 11 cases. Many of the Commissioners commented that although valuation litigation can be time-consuming and expensive,[689] judicial valuation and any related uncertainty can encourage negotiated resolutions.[690] A negotiated resolution of valuation uncertainty aligns with the consensual nature of the chapter 11 process. Although disputes arise and not every chapter 11 is consensual, commentators typically describe "the goal of a Chapter 11 restructuring [as achieving] a consensual plan of reorganization."[691] Chapter 11's preference for consensual resolutions evolved at least in part from business reorganization's Chapter XI roots. A consensual plan between the debtor and its unsecured creditors was the hallmark of the Chapter XI process under the Bankruptcy Act.[692]

The Commissioners found continued utility in the judicial valuation approach, including the flexibility it gives the parties in selecting the best valuation methodology. Judicial valuation allows the court and parties to consider market valuations, book and adjusted book valuations, and other factors that may be relevant to particular debtor and its reorganization efforts. The Commissioners were also mindful, however, of witness

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[685] 1977 House Judiciary Committee Report on Public Law 95-598, at 222.

[686] *See* Baird & Bernstein, *supra* note 683, at 1943 ("Differences of 10% are almost inevitable, and often the differences are far larger.").

[687] Stuart C. Gilson et al, *Valuation of Bankrupt Firms*, 13 Rev. Fin. Studies 43–74 (2000) ("This study explores the relation between the market value of 63 publicly traded firms emerging from Chapter 11 and the values implied by the cash flow forecasts in their reorganization plans.").

[688] *Id.*

[689] *In re* Mirant Corp., 334 B.R. 800, 809, 824 (Bankr. N.D. Tex. 2005) (conducting 27-day valuation trial with separate valuation experts for key parties testifying to values ranging from $7.2 billion to $13.6 billion).

[690] *See* Baird & Bernstein, *supra* note 683, at 1963 ("These dynamics regularly lead to negotiated reorganization plans with basic features consistent with the idea that valuation uncertainty plays a key role in dictating the contours of such plans.").

[691] Miller & Waisman, *Is Chapter 11 Bankrupt?*, *supra* note 26, at 144–45.

[692] For discussion of Chapter XI of the Bankruptcy Act, see Section III.A, *Brief History of U.S. Business Reorganization Laws*.

testimony suggesting that judges may need assistance with complex or contested valuations. For example, the Honorable James Peck of the U.S. Bankruptcy Court for the Southern District of New York testified as follows:

> An inexperienced judge navigating unfamiliar territory introduces an extra element of risk and uncertainty into what necessarily is an unpredictable process in which the skills and personality of the advocate and witness may be the most important variables. An experienced judge is likely to be more facile in deciding these questions but reliability and predictability remain a problem because the experienced judge will be applying his or her own valuation judgments without being able to confer with someone deeply grounded in the subject. Such a valuation professional would be more skilled than most judges in being able to verify or question the assumptions and adjustments that so often dictate the conclusions reached. Valuation is an art more than a science, and it would be helpful for the Court to have access to a seasoned art critic in deciding whether a particular challenged valuation is genuine or a fake.[693]

The Commission reviewed witness testimony and related anecdotal evidence on valuation. The Commission agreed that courts should be permitted and encouraged to appoint valuation experts in cases in which such an expert can provide assistance to the court. The Commissioners debated whether an appointed expert should be permitted to consult with, and to advise the court, but not necessarily be called to testify in the case. After debating the benefits to the court and the due process and procedural concerns for the parties, the Commission agreed that, if the court intends to rely on the court-appointed valuation expert, such expert must testify in the case and be subject to cross-examination. The Commissioners also observed that estate neutrals under the recommended principles could now perform the expanded role, including that of mediator, served by court appointed valuation experts in the past. Finally, the Commissioners evaluated the language of Rule 706 of the Federal Rules of Evidence and found it sufficient as written for the contemplated role of court-appointed valuation experts.

G. Standard for Reviewing Settlements and Compromises

Recommended Principles:

- The principles and standards of Bankruptcy Rule 9019 should be codified to foster uniform application of a court's authority to approve a settlement or compromise of controversies in a chapter 11 case. Accordingly, the court, after notice and a hearing, should approve a trustee's proposed settlement or compromise of a controversy only if the court finds, based on the evidence

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[693] *Written Statement of Honorable James M. Peck, VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Feb. 21, 2013), *available at* Commission website, *supra* note 55.

> presented, that the proposed settlement or compromise is reasonable and in the best interests of the estate.

a. Standard for Reviewing Settlements and Compromises: Background

In general, "compromises are favored in bankruptcy."[694] Negotiated resolutions of disputes can create efficiencies in the process and cost savings for the parties. Bankruptcy Rule 9019, like its predecessor Rule 919 under the Bankruptcy Act, provides a process for parties to request court approval of settlements and compromises. Specifically, Bankruptcy Rule 9109 states, in relevant part: "On motion by the trustee and after notice and a hearing, the court may approve a compromise or settlement."[695] Notably, neither the Bankruptcy Rules nor the Bankruptcy Code provide a standard or criteria for the court to use in assessing proposed settlements and compromises.

Given general bankruptcy policy and the lack of guidance in the Bankruptcy Rules and the Bankruptcy Code, courts tend to invoke a "presumption in favor of settlements," and approve a proposed settlement or compromise unless it "'fall[s] below the lowest point in the range of reasonableness.'"[696] Various courts have developed factors to assist in this determination, but not all courts use the same factors or apply the factors in a uniform manner.[697] This variation can cause uncertainty for the parties filing motions under Bankruptcy Rule 9019 and inconsistent rulings on proposed settlements and compromises. In addition, courts take different approaches to reviewing settlements and compromises incorporated into plans of reorganization.[698] This latter issue is discussed below.[699]

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[694] Myers v. Martin (*In re* Martin), 91 F.3d 389, 393 (3d Cir. 1996) (quoting 9 Collier on Bankruptcy ¶ 9019.03[1] (15th ed. 1993)).

[695] Fed. R. Bankr. P. 9019(a).

[696] *In re* Tower Auto., Inc., 342 B.R. 158, 164 (Bankr. S.D.N.Y. 2006), *aff 'd*, 241 F.R.D. 162 (S.D.N.Y. 2006). *See also* Hicks, Muse & Co., Inc. v. Brandt (*In re* Healthco Int'l, Inc.), 136 F.3d 45, 50 n.5 (1st Cir. 1998) (holding that court may accord deference to the position of the trustee or debtor in possession); *In re* WorldCom, Inc., 347 B.R. 123, 137 (Bankr. S.D.N.Y. 2006) ("While the bankruptcy court may consider the objections lodged by parties in interest, such objections are not controlling . . . the bankruptcy court must still make informed and independent judgment."); *In re* Hibbard Brown & Co., Inc., 217 B.R. 41, 46 (Bankr. S.D.N.Y. 1998) (holding that court may exercise its discretion under Bankruptcy Rule 9019 "in light of the general public policy favoring settlements").

[697] Courts consider a variety of factors, including:

> (1) the balance between the litigation's possibility of success and the settlement's future benefits; (2) the likelihood of complex and protracted litigation, with its attendant expense, inconvenience and delay, including the difficulty in collecting on the judgment; (3) the paramount interests of the creditors, including each affected class's relative benefits and the degree to which creditors either do not object to or affirmatively support the proposed settlement; (4) whether other parties in interest support the settlement; (5) the competency and experience of counsel supporting, and the experience and knowledge of the bankruptcy court judge reviewing, the settlement; (6) the nature and breadth of releases to be obtained by officers and directors; and (7) the extent to which the settlement is the product of arm's length bargaining.

In re Iridium Operating LLC, 478 F.3d 452, 462 (2d Cir. 2007) (internal citations omitted). Although several of these factors were developed by courts in the plan settlement context, they also apply outside the plan context in certain instances.

[698] A related but different issue arises when the proposed settlement "has the effect of dictating the terms of a prospective chapter 11 plan." *In re* Capmark Fin. Grp. Inc., 438 B.R. 471, 513 (Bankr. D. Del. 2010). In those instances, courts may deny approval of the settlement because it constitutes an impermissible *sub rosa* plan. *See*

b. Standard for Reviewing Settlements and Compromises: Recommendations and Findings

A trustee[700] may seek to settle any number of disputes in the chapter 11 case, including claims resolution matters, avoidance claims, and pre-petition litigation. Because any such settlement necessarily impacts the estate — either because the estate will fund at least a portion of the settlement or the estate's claims against third parties are being compromised — the court and parties in interest should have an opportunity to review the terms of the proposed settlement. The settlement or compromise also should be subject to court approval.

The Commissioners discussed the soundness of the notice and hearing process required by Bankruptcy Rule 9019, but acknowledged the discretion given the trustee in presenting the settlement, and the court in approving or denying the settlement. Beyond requiring notice and a hearing, Bankruptcy Rule 9019 establishes no parameters for the content or timing of settlements. It also does not set forth a standard or criteria for the assessment of settlements. The Commission agreed that codifying the settlement approval process, including an appropriate standard of review, would further facilitate the bankruptcy policy of encouraging consensual resolution of disputed matters.

The Commission reviewed the courts' various approaches to assessing proposed settlements and compromises under Bankruptcy Rule 9019. This review identified a wide range of approaches, from "the lowest point of reasonableness" to the "fair and equitable" standard used to evaluate compromises and plans under the Bankruptcy Act. The Commissioners generally agreed that the lowest point of reasonableness standard did not sufficiently scrutinize the terms of the proposed settlement and its impact on the estate. Several Commissioners suggested using the fair and equitable standard as applied by the U.S. Supreme Court in *TMT Trailer Ferry*.[701] Other Commissioners expressed concern regarding the ambiguity surrounding "fair and equitable" and its common association with approval of a chapter 11 plan in the cramdown context.[702] The Commissioners generally agreed that something less than fair and equitable, but still meaningful, should govern the approval of settlements and compromises.

After discussing different approaches, the Commission agreed to use a hybrid standard that requires the settlement or compromise to be "reasonable and in the best interests of the estate." It favored this standard because it would adequately protect the estate and allow the court to weigh the evidence presented on the particular settlement

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generally Craig A. Sloane, *The* Sub Rosa *Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37 (1999).

[699] *See* Section VI.F.4, *Settlements and Compromises in Plan*.

[700] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[701] Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968).

[702] The fair and equitable standard is used in the cramdown context under section 1129 of the Bankruptcy Code. The Bankruptcy Code also incorporates elements necessary to make a plan fair and equitable to any particular class of creditors or equity securities holders that reject the plan.

or compromise. Although the Commission believed that the proposed "reasonable and in the best interests of the estate standard" is better suited than a "fair and equitable" standard for the review and approval of settlements and compromises, it also believed that courts should still engage in a totality of the circumstances analysis that considers factors such as those articulated by courts under the fair and equitable approach.[703]

H. The In Pari Delicto *Doctrine*

Recommended Principles:

- The *in pari delicto* defense should be inapplicable to claims for relief that a trustee appointed under section 1104 in the chapter 11 case asserts against third parties under section 541 of the Bankruptcy Code. The absence of the *in pari delicto* defense should not otherwise affect the trustee's burden to establish the claims for relief under applicable law.
- The Commission was unable to reach a consensus on eliminating the *in pari delicto* defense with respect to claims for relief that other estate fiduciaries or parties authorized to act on behalf of the estate (e.g., litigation trustees, postconfirmation entities, unsecured creditors' committees, debtors in possession) might assert against third parties under the Bankruptcy Code.

a. The In Pari Delicto *Doctrine: Background*

The Latin phrase *in pari delicto* means "in equal fault,"[704] and the *in pari delicto* doctrine generally bars the pursuit of a cause of action by a plaintiff who allegedly acted in concert with the defendants, or was otherwise involved, in the wrongful conduct underlying the plaintiff 's complaint. The *in pari delicto* doctrine is "grounded on two premises: first, that courts should not lend their good offices to mediating disputes among wrongdoers; and second, that denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[705] The *in pari delicto* issue arises in a variety of instances in chapter 11 cases, but perhaps most commonly in cases precipitated by a pre-petition Ponzi scheme.[706]

In many cases, the underlying cause of action is grounded in pre-petition conduct and belongs to the estate under section 541 of the Bankruptcy Code. The target defendant might be an accountant, auditor, attorney, bank, broker, insider, or others. The state law claim might be aiding and abetting fraud, breach of fiduciary duty,

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[703] *See, e.g.*, Protective Comm. for Indep. Stockholders of TMT Trailer Ferry, Inc. v. Anderson, 390 U.S. 414, 424–25 (1968) ("[T]he judge should form an educated estimate of the complexity, expense, and likely duration of such litigation, the possible difficulties of collecting on any judgment which might be obtained, and all other factors relevant to a full and fair assessment of the wisdom of the proposed compromise.").

[704] *See, e.g.*, Bateman Eichler, Hill Richards, Inc. v. Berner, 472 U.S. 299, 306 (1985).

[705] Mosier v. Callister, Nebeker & McCullough PC, 546 F.3d 1271, 1275 (10th Cir. 2008).

[706] In the context of reviewing fraudulent transfer law under section 548 of the Bankruptcy Code, the Commission considered codifying the "Ponzi scheme presumption," which would basically create a rebuttable presumption that transfers made in furtherance of a Ponzi scheme are fraudulent transfers subject to avoidance. *See, e.g., In re* Manhattan Inv. Fund Ltd., 397 B.R. 1, 11–13 (S.D.N.Y. 2007). The term "Ponzi scheme" is not well defined under the case law. *Id.* After much deliberation, the Commission decided that this issue was best left to further development under the case law.

negligence, malpractice, aiding and abetting breach of fiduciary duty, negligent misrepresentation, negligent supervision, or conspiracy. Among the defendant's affirmative defenses is *in pari delicto*. Under present law, because the debtor's wrongdoing would bar any recovery by the debtor, the trustee is likewise entitled to no relief. Every circuit except the Ninth Circuit has ruled on the issue and has held that, under section 541, the *in pari delicto* doctrine bars a trustee's claims when the doctrine would bar the claims if brought by the debtor.[707]

Courts have recognized certain exceptions to the application of the *in pari delicto* doctrine. For example, the "adverse interest" exception provides that if the officers and directors of the debtor who participated in the fraudulent transactions were acting in their own interests and to the detriment of the debtor, then the adverse interest exception defeats the *in pari delicto* doctrine.[708] Another exception, known as the "innocent decision maker" exception, may apply if not all of the "shareholders or decision makers are involved in the fraud" — i.e., there was at least one innocent insider to whom the defendant could have reported their findings.[709] Some courts have found the innocent decision maker exception inapplicable, however, when an innocent member of management "could and would have prevented the fraud had they been aware of it."[710]

In addition, the *in pari delicto* doctrine applies only to a trustee's claims under section 541. Accordingly, courts have determined that the doctrine should not apply to,

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[707] *See, e.g.*, Peterson v. McGladrey & Pullen, LLP (*In re* Lancelot Investors Fund, L.P.), 676 F.3d 594 (7th Cir. 2012); Gray v. Evercore Restructuring L.L.C., 544 F.3d 320, 324–25 (5th Cir. 2008); Mosier v. Callister, Nebeker & McCullough, 546 F.3d 1271, 1276 (10th Cir. 2008); Baena v. KPMG LLP, 453 F.3d 1, 6 (1st Cir. 2006); Nisselson v. Lernout, 469 F.3d 143, 153 (1st Cir. 2006), *cert. denied*, 550 U.S. 918 (2007); Official Comm. of Unsecured Creditors of PSA, Inc. v. Edwards, 437 F.3d 1145, 1149–56 (11th Cir. 2006), *cert. denied*, 549 U.S. 811 (2006); Grassmueck v. Am. Shorthorn Ass'n, 402 F.3d 833, 836–37 (8th Cir. 2005); Logan v. JKV Real Estate Servs. (*In re* Bogdan), 414 F.3d 507, 514–15 (4th Cir. 2005), *cert. denied*, 546 U.S. 1093 (2006) (noting exception where claims have been assigned to trustee); Official Comm. of Unsecured Creditors of Color Tile, Inc., v. Coopers & Lybrand, LLP, 322 F.3d 147, 158 (2d Cir. 2003); Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., Inc., 267 F.3d 340, 354–60 (3d Cir. 2001); Terlecky v. Hurd (*In re* Dublin Sec., Inc.), 133 F.3d 377, 380 (6th Cir. 1997), *cert. denied*, 525 U.S. 812 (1998); Sender v. Buchanan (*In re* Hedged-Invs. Assocs., Inc.), 84 F.3d 1281, 1284–86 (10th Cir. 1996); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094–95 (2d Cir. 1995); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118–20 (2d Cir. 1991). *But see* USACM Liquidating Trust v. Deloitte & Touche, 754 F.3d 645, 649 (9th Cir. 2014), *aff 'g* 764 F. Supp. 2d 1210, 1229 (D. Nev. 2011). Notably, the Second Circuit appears to treat the issue not as a defense like the other circuits, but as an issue of standing. *See* Breeden v. Kirkpatrick & Lockhart LLP (*In re* Bennett Funding Grp., Inc.), 336 F.3d 94, 100 (2d Cir. 2003); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1094–95 (2d Cir. 1995); Shearson Lehman Hutton, Inc. v. Wagoner, 944 F.2d 114, 118 (2d Cir. 1991).

[708] Bankruptcy Servs., Inc. v. Ernst & Young (*In re* CBI Holding Co., Inc.), 529 F.3d 432 (2d Cir. 2008). Importantly, there are variations on the adverse interest exception. For example, some courts narrowly interpret the exception to apply when the guilty manager has "totally abandoned" the interest of the principal corporation, while other courts engage in an analysis of the respective benefits received by the corporate entity and the wrongdoer insider, Thabault v. Chait, 541 F.3d 512, 527 (3d Cir. 2008); Baena v. KPMG, LLP, 453 F.3d 1, 8 (1st Cir. 2006); Breeden v. Kirkpatrick & Lockhard LLP (*In re* Bennett Funding Grp.), 336 F.3d 94, 100 (2d Cir. 2003). Other courts have found that the adverse interest exception should be determined by the agent's subjective motives, rather than by a strict rule of whether the debtor received any benefit as a result of the agent's activities, Bankruptcy Servs. Inc. v. Ernst & Young (*In re* CBI Holding Co., Inc.), 529 F.3d 432, 451 (2d Cir. 2008).

[709] Smith v. Andersen L.L.P., 175 F. Supp. 2d 1180, 1199 (D. Ariz. 2001); Breeden v. Kirkpatrick & Lockhart, LLP, 268 B.R. 704, 710 (S.D.N.Y. 2001), *aff 'd, In re* Bennett Funding Group, Inc., 336 F.3d 94 (2d Cir. 2003); SIPC v. BDO Seidman, LLP, 49 F. Supp. 2d 644, 650 (S.D.N.Y. 1999), *aff 'd in part*, 222 F.3d 63 (2d Cir. 2000).

[710] *See, e.g.*, *In re* CBI Holding Co., Inc., 311 B.R. 350, 372 (S.D.N.Y. 2004), *aff 'd in part, rev'd in part*, 529 F.3d 432 (2d Cir. 2008).

for example, the trustee's "strong arm" claims under section 544;[711] preference claims under section 547;[712] and fraudulent transfer claims under section 548.[713]

Despite the various exceptions, the *in pari delicto* doctrine may preclude the trustee from pursuing causes of action that benefit the estate and the beneficiaries of the estate who are innocent victims as to the underlying cause of action. Several commentators thus have questioned the relevance and fairness of applying the *in pari delicto* doctrine in bankruptcy cases. These commentators note, among other things, that state and federal law receivers generally are not subject to the *in pari delicto* defense.[714] The question persists whether trustees in bankruptcy should have the same ability to pursue actions against third parties to the same extent as a state law receiver (or a receiver under the Federal Depository Insurance Act or the federal securities laws), or whether trustees should be treated differently, given the bankruptcy maxim that a trustee stands in the shoes of the debtor and is subject to the same defenses as the debtor.[715]

b. The In Pari Delicto *Doctrine: Recommendations and Findings*

The *in pari delicto* doctrine's application to certain of a trustee's or other estate representative's claims against third parties in a bankruptcy case is subject to much debate in the literature. The conclusion that parties cannot assert the *in pari delicto*

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[711] Kaliner v. MDC Sys. Corp., LLC, 2011 U.S. Dist. LEXIS 5377, at *15 (E.D. Pa. Jan. 20, 2011).

[712] *See, e.g., In re* CBI Holding, Inc., 311 B.R. 350, 372 (S.D.N.Y. 2004), *aff 'd in part, rev'd in part*, 529 F.3d 432 (2d Cir. 2008).

[713] McNamara v. PFS (*In re* Pers. & Bus. Ins. Agency), 334 F.3d 239, 245–47 (3d Cir. 2003).

[714] *See* FDIC v. O'Melveny & Myers, 61 F.3d 17, 18–19 (9th Cir. 1995); Scholes v. Lehmann, 56 F.3d 750, 754–55 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995); Goldberg v. Chong, 2007 U.S. Dist. LEXIS 49980, *28–29 (S.D. Fla. July 11, 2007).

[715] Some courts follow the bankruptcy analogy and conclude that because the receiver simply steps into the shoes of the receivership entity in pursuing the entity's claims, and because the *in pari delicto* doctrine would bar the entity's claim, it bars the receiver's claim. *See, e.g.*, Wuliger v. Mfrs. Life Ins. Co., 567 F.3d 787, 792 (6th Cir. 2009); Knauer v. Jonathon Roberts Fin. Grp., Inc., 348 F.3d 230, 236 (7th Cir. 2003); *In re* Wiand, 2007 WL 963165, at *6–7 (M.D. Fla. Mar. 27, 2007). Other courts conclude that because the receiver's role is to protect innocent investors, and because these investors were not complicit in the fraud, the *in pari delicto* doctrine does not bar the receiver's claim. *See, e.g.*, Jones v. Wells Fargo Bank, N.A., 666 F.3d 955, 966 (5th Cir. 2012) ("A receiver is 'the representative and protector of the interests of all persons, including creditors, shareholders and others, in the property of the receivership.' . . . The receiver has a duty to pursue a corporation's claims.' . . . Although a receiver generally 'has no greater powers than the corporation had as of the date of the receivership,' it is well established that 'when the receiver acts to protect innocent creditors . . . he can maintain and defend actions done in fraud of creditors even though the corporation would not be permitted to do so.' . . . The receiver thus acts on behalf of the corporation as a whole, an entity separate from its individual bad actors.") (citations omitted); FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) ("A receiver, like a bankruptcy trustee and unlike a normal successor in interest, does not voluntarily step into the shoes of the bank; it is thrust into those shoes. It was neither a party to the original inequitable conduct nor is it in a position to take action prior to assuming the bank's assets to cure any associated defects or force the bank to pay for incurable defects. This places the receiver in stark contrast to the normal successor in interest who voluntarily purchases a bank or its assets and can adjust the purchase price for the diminished value of the bank's assets due to their associated equitable defenses. In such cases, the bank receives less consideration for its assets because of its inequitable conduct, thus bearing the cost of its own wrong."); Javitch v. Transamerica Occidental Life Ins. Co., 408 F. Supp. 2d 531, 538 (N.D. Ohio 2006) ("An equity receiver's duties are fashioned and may be modified by the appointing court. Because this Court has expressly given the Receiver's broad authority to pursue claims on behalf of Liberte and the investors, the Receiver is not precluded from these actions under the doctrine of *in pari delicto*."); Isp.com LLC v. Theising, 805 N.E.2d 767, 773 (Ind. 2004) ("The receiver is in some respects a new entity, untainted by the corporation's wrongdoing. He is not necessarily barred by *in pari delicto*.").

defense against claims that are available only to the trustee in a bankruptcy case — such as preference claims and fraudulent conveyance claims — is well supported. A debtor has no rights in, or ability to pursue, such claims, and the trustee does not stand in the shoes of the debtor for purposes of those actions. Pre-petition claims of the debtor that become property of the estate under section 541 of the Bankruptcy Code may, however, require a different analysis. The Commission considered current trends in the case law on the *in pari delicto* doctrine, the underlying justifications for the doctrine, and whether a trustee or estate representative should be subject to the *in pari delicto* defense in bankruptcy, irrespective of the genesis of the claims.

The Commission reviewed the primary purposes of the *in pari delicto* doctrine, most commonly articulated as follows: that "courts should not lend their good offices to mediating disputes among wrongdoers" and "denying judicial relief to an admitted wrongdoer is an effective means of deterring illegality."[716] The Commissioners generally agreed that the doctrine served these basic goals when applied outside of bankruptcy: a company that participated in a wrong should not be able to benefit from that wrong. For some of the Commissioners, however, the intervention of a bankruptcy case changed the calculus dramatically.

In bankruptcy, a party not involved with the alleged pre-petition wrongdoing may bring the action for the benefit of the estate (e.g., innocent creditors of the debtor). That party typically is the trustee, unsecured creditors' committee, litigation trustee, or other estate representative. The trustee, unsecured creditors' committee, litigation trustee, or other estate representative did not participate in the wrong and is not seeking recoveries that would benefit any of the wrongdoers. Indeed, to the extent that the debtor's pre-petition shareholders, officers, or directors who may have been involved with the alleged wrongdoing are creditors of the estate, those claimants can be barred from receiving any recoveries from the litigation.

Several of the Commissioners found the case for not allowing third parties to assert the *in pari delicto* defense against the trustee or other estate representative very compelling. These Commissioners emphasized the distinction between the pre-petition debtor company and a trustee or litigation trust for purposes of the defense. They posited that the justifications for the *in pari delicto* doctrine, as articulated above, simply did not apply in the trustee context. In fact, they noted that innocent creditors actually were being penalized because, outside of bankruptcy: (i) state law receivers and receivers appointed by the Securities and Exchange Commission or the Federal Depository Insurance Company could pursue claims previously belonging to the alleged company wrongdoer and not be subject to the defense;[717] and (ii) individual creditors harmed by the wrong could sue the third parties without being subject to the defense.[718]

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[716] Official Comm. of Unsecured Creditors of PSA Inc. v. Edwards, 437 F.3d 1145 (11th Cir. 2006), *cert. denied*, 549 U.S. 811 (2006).

[717] O'Melveny & Myers v. FDIC, 512 U.S. 79 (1994) (remanding on grounds that state law should determine if defense applies). On remand, the Ninth Circuit held that the defense did not apply to receiver even under California law. FDIC v. O'Melveny & Myers, 61 F.3d 17 (9th Cir. 1995). *See also* Scholes v. Lehmann, 56 F.3d 750, 754 (7th Cir. 1995), *cert. denied*, 516 U.S. 1028 (1995) ("Put differently, the defense of *in pari delicto* loses its sting when the person who is *in pari delicto* is eliminated.").

[718] FDIC v. O'Melveny & Myers, 61 F.3d 17, 19 (9th Cir. 1995) ("While a party may itself be denied a right or defense on account of its misdeeds, there is little reason to impose the same punishment on a trustee, receiver or similar innocent entity that steps into the party's shoes pursuant to court order or operation of law. Moreover, when

The Commissioners supporting elimination of the *in pari delicto* defense in bankruptcy viewed its enforcement as penalizing the debtor's innocent creditors, who likely were already suffering losses as a result of the bankruptcy itself.

The Commissioners parsed through the likely practical implications of eliminating the *in pari delicto* defense in bankruptcy. The Commissioners acknowledged that including the debtor in possession in the concept of an "estate representative" not subject to the *in pari delicto* defense may raise closer policy issues. Although the debtor in possession has a legal status different from the pre-petition debtor under the Bankruptcy Code, the Commissioners acknowledged that the debtor in possession could still employ some of the individuals who allegedly participated on behalf of the debtor in the wrongdoing. They also presented a closer conceptual question on the policy issues. Some of the Commissioners supported including the debtor in possession among the estate representatives that should not be subject to the *in pari delicto* defense.[719] Some of the Commissioners believed it was more important to eliminate the defense, at least as to bankruptcy trustees, and then also as to unsecured creditors' committees, litigation trustees, and similar estate representatives that were not affiliated with the pre-petition debtor.

Other Commissioners voiced concern that any change to the current law essentially would create a new cause of action for the estate not otherwise available under state law. These Commissioners focused on the fact that the debtor (or an entity acting on behalf of the debtor) generally could not pursue such claims under nonbankruptcy law, unless a receiver was appointed.[720] They believed that eliminating the *in pari delicto* defense in bankruptcy directly conflicted with the long-standing principle that bankruptcy does not enhance a debtor's rights in property.[721] From that principle flow the equally important concepts that the estate's interest in property is limited to that held by the debtor pre-petition, and that the trustee steps into the debtor's shoes with respect to those property interests and is subject to any defenses otherwise applicable against the debtor.[722] These Commissioners could not reconcile these principles with the elimination of the *in pari delicto* defense. They also pointed to the inherent unfairness of allowing the principal wrongdoer, or someone standing in the shoes of the

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a party is denied a defense under such circumstances, the opposing party enjoys a windfall. This is justifiable as against the wrongdoer himself, not against the wrongdoer's innocent creditors.").

[719] These Commissioners noted that, in most cases, management of the old debtor has been replaced or a Chief Restructuring Officer has been appointed.

[720] These Commissioners noted that the receiver context was different than the collective action process of bankruptcy and believed that the different treatment was justified on that basis.

[721] *See, e.g.*, S. Rep. No. 95-989, at 82 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787; H.R. Rep. No. 95-595, at 367–68 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963 (explaining that section 541 cannot "expand the debtor's rights against others more than they exist at the commencement of the case").

[722] *See, e.g.*, McNamara v. PFS (*In re* Personal & Bus. Ins. Agency), 334 F.3d 239, 245 (3d Cir. 2003) ("[I]n actions brought by the trustee as successor to the debtor's interest under section 541, the 'trustee stands in the shoes of the debtor and can only assert those causes of action possessed by the debtor. [Conversely,] the trustee is, of course, subject to the same defenses as could have been asserted by the defendant had the action been instituted by the debtor.'") (quoting Official Comm. of Unsecured Creditors v. R.F. Lafferty & Co., 267 F.3d 340, 356 (3d Cir. 2001)); Hirsch v. Arthur Andersen & Co., 72 F.3d 1085, 1093 (2d Cir. 1995) ("[T] he trustee stands in the shoes of the debtors, and can only maintain those actions that the debtors could have brought prior to the bankruptcy proceedings.").

wrongdoer, to prosecute a claim against a party who may have been negligent when the wrongdoer's conduct was intentional (i.e., the defendant is liable to the plaintiff because it negligently failed to detect the plaintiff 's intentionally concealed fraud).

These Commissioners objected not only to eliminating the defense as to a debtor in possession but also as to the trustee and any other estate representative. They argued that it would be bad policy to allow an estate representative to pursue professionals and institutions on claims that may lack merit and for which one of the alleged wrongdoers — the debtor — is not subject to collection actions. They suggested that such a proposal would encourage "shakedowns" and unfounded settlements because defendants would be forced to settle (regardless of merit) to avoid the risk of potentially significant liability. They likewise noted that eliminating the defense could skew incentives and create unintended challenges for professionals in the distressed industry.

The Commissioners supporting the elimination of the *in pari delicto* defense in bankruptcy focused on the parties represented by the trustee in bankruptcy — e.g., typically general unsecured creditors. They repeatedly emphasized that these creditors are innocent in the process and generally harmed by the types of wrongful conduct alleged in lawsuits in which third parties may assert the *in pari delicto* defense. They suggested that eliminating just the *in pari delicto* defense and preserving a defendant's other defenses would strike the appropriate balance between the bankruptcy policy of allowing an estate representative to pursue claims to maximize the value of the estate for the benefit of creditors and allowing parties to appropriately defend themselves in unfounded litigation. From this perspective, allowing defendants to assert the *in pari delicto* defense against the bankruptcy trustee would place the trustee (and creditors) at a significant disadvantage and provide defendants with a shield that they would not be able to use under state or federal receivership law.

The Commission explored several alternatives for bridging the disparate views of the Commissioners on this issue. Some of the Commissioners suggested a compromise of a federal comparative default rule for these actions, wherein the *in pari delicto* defense would not be available, but defendants could assert that the debtor or its management was primarily at fault. Others suggested modifications to this proposal that would allow defendants to assert that they should not be liable because they were not primarily at fault (i.e., the debtor or another defendant was primarily at fault). The Commissioners expressed concern that this approach would only result in finger-pointing and not serve the purpose of compensating the estate and creditors for pre-petition wrongs against their interests.

The Commission then attempted to identify areas of agreement to build consensus on this issue. First, the Commissioners discussed allowing individual creditors to pursue claims that they in fact hold under applicable nonbankruptcy law against third parties allegedly acting in concert with the pre-petition debtor free of the *in pari delicto* defense (which would not be applicable in any event) in the bankruptcy case. The Commissioners were generally comfortable with this approach, provided that any recoveries were available only to those creditors holding the claims. Second, the Commissioners discussed allowing a creditor or creditors to pursue such claims in the bankruptcy case on behalf of all creditors when a generalized harm existed. The Commission was fairly evenly split on this component, with some arguing that, in

substance, it was no different than allowing an estate representative to bring the claim free of the *in pari delicto* defense.

After extensive deliberation, the Commission recommended the elimination of the *in pari delicto* defense solely with respect to any trustee appointed in the chapter 11 case. The Commission determined that this modification would provide the trustee with rights similar to those possessed by receivers in other contexts, and it would not expose defendants to claims brought by a party controlled or influenced by alleged wrongdoers (e.g., directors, officers, or employees of the debtor). The Commission viewed this as an extension of the potential liability of defendants outside of bankruptcy, where creditors (or a receiver on behalf of creditors) could assert claims not subject to the *in pari delicto* defense, and not as a significant expansion of the trustee's powers against the defendants in bankruptcy. The Commission did not reach a position with respect to the availability of the *in pari delicto* defense in actions brought by other estate representatives, the debtor in possession, or unsecured creditors' committees. Accordingly, the Commission is not making a proposal on the *in pari delicto* defense in actions brought by those entities in the chapter 11 case.

V. PROPOSED RECOMMENDATIONS: EXITING THE CASE

A. General Authority of Debtor in Possession and Its Board of Directors

1. Preemption and the Authority to Approve Transactions and Plan

Recommended Principles:

- A debtor in possession's board of directors or similar governing body should be able to act on behalf of the debtor in possession in the chapter 11 case without seeking or obtaining approval of the debtor's equity security holders, including with respect to transactions under section 363 of the Bankruptcy Code. Accordingly, the Bankruptcy Code should preempt any applicable state entity governance law on these matters, and section 1107 should be amended.
- An order of the court confirming a plan under section 1129 of the Bankruptcy Code should govern the implementation of all transactions contemplated by the plan in accordance with section 1123(a)(5) and preempt any applicable nonbankruptcy law. Sections 1141 and 1142 should be amended to clarify this point.
- The preemptive effect of the chapter 11 plan, confirmation order, or section 363x sale order with respect to transactions included therein should not relieve the directors, officers, or similar managing persons of the debtor, debtor in possession, or reorganized debtor of their fiduciary duties under applicable state entity governance law in implementing or affecting any transactions under the plan or sale order.

a. Preemption and the Authority to Approve Transactions and Plan: Background

In general, the Bankruptcy Code defers to state law governance principles with respect to the fiduciary duties of a debtor in possession's[723] governing body, whether a board of directors, board of managers, or similar concentrated management structure, as well as its directors, officers, or similar managing persons.[724] As discussed above, this deference generally means that those individuals or entities owe the duties of care and loyalty, and an obligation of good faith.[725] These state law duties and obligations govern the conduct of those individuals or entities in operating the business and managing its affairs. In addition, state or other applicable nonbankruptcy law may require the debtor in possession or its governing body to obtain approvals or satisfy specified conditions before taking certain actions for, or on behalf of, the debtor.

For example, state law or the debtor's charter may require the debtor's board of directors to obtain the approval of shareholders before selling all or substantially all of the debtor's assets.[726] State law also may require the board of directors to hold an annual shareholders meeting. Although courts commonly allow a debtor in possession to sell all or substantially all of its assets under section 363(b) of the Bankruptcy Code without seeking or obtaining shareholder approval, courts have taken a different approach to the shareholders meeting requirement. Most courts review a demand on the debtor in possession to hold the annual shareholders meeting under a "clear abuse" standard, which considers whether the shareholders' rights to vote for directors "and thus to control corporate policy . . . will not be disturbed unless a clear case of abuse is made out."[727] Some courts have, however, enjoined the shareholders meeting or denied a shareholder's request to compel the meeting when the strategic objectives of the requesting shareholders are determined to be adverse to the interests of the estate.[728]

Additionally, a debtor's chapter 11 plan will likely propose a new capital structure and new board members or managers, and it may propose a merger or other change in control transaction, as well as other various actions required or permitted by section 1123 of the Bankruptcy Code. Section 1123(a)(5) specifically provides:

> (a) Notwithstanding any otherwise applicable nonbankruptcy law, a plan shall — . . .

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[723] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[724] *See, e.g.*, David A. Skeel, *Rethinking the Line Between Corporate Law and Corporate Bankruptcy*, 72 Tex. L. Rev. 471, 491 (1994) (explaining tradition deference to state governance law). *See also* Fogel v. U.S. Energy Sys., Inc., 2008 WL 151857, at *1 (Del. Ch. Jan. 15, 2008) ("[C]orporate governance does not cease when a company files a petition under Chapter 11 and that issues of corporate governance are best left to the courts of the state of incorporation.").

[725] *See* Section IV.A.1, *The Debtor in Possession Model*.

[726] *See* Esopus Creek Value LP v. Hauf, 913 A.2d 593, 596, 605–06 (Del. Ch. 2006). *See also* Del. Code Ann. tit. 8, § 271(a) (2008) (requiring a majority of shareholders to approve the sale of all or substantially all of a corporation's property and assets).

[727] Fogel v. U.S. Energy Sys., Inc., 2008 WL 151857, at *1 (Del. Ch. Jan. 15, 2008) (citing *In re* Lionel Corp., 30 B.R. 327, 329–30 (Bankr. S.D.N.Y. 1983)).

[728] *See, e.g.*, Manville Corp. v. Equity Sec. Holders Comm. (In re Johns-Manville Corp.), 801 F.2d 60 (2d Cir. 1986) (discussing court's ability to limit shareholders' rights during chapter 11 case).

> (5) provide adequate means for the plan's implementation, 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, whether organized before or after the confirmation of such plan;
> (C) merger or consolidation of the debtor with one or more persons;
> (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; or
> (J) issuance of securities of the debtor, or of any entity referred to in subparagraph (B) or (C) of this paragraph, for cash, for property, for existing securities, or in exchange for claims or interests, or for any other appropriate purpose;[729]

The legislative history of section 1123(a)(5) provides that the section is "intended to indicate that a plan may provide for any action specified in section 1123 in the case of a corporation without a resolution of the board of directors" and, if confirmed, "any action proposed in the plan may be taken notwithstanding any otherwise applicable nonbankruptcy law in accordance with section 1142(a) [of the Bankruptcy Code]."[730]

The phrase "[n]otwithstanding any otherwise applicable nonbankruptcy law" was added to section 1123 in 1984 to clarify the preemptive nature of the section. Nevertheless, the Ninth Circuit Court of Appeals has read section 1123(a)(5) narrowly to limit its preemptive effect to the scope of section 1142(a), which arguably is limited to "applicable nonbankruptcy law, rule, or regulation relating to financial condition."[731] Other courts have, however, declined to graft section 1142(a)'s limitation onto section 1123(a), noting that Congress used different language in section 1123(a), even though it was aware of section 1142(a)'s language at the time of the amendment.[732]

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[729] 11 U.S.C. § 1123(a)(5). *See also* 7 Collier on Bankruptcy ¶ 1123.01[5] (16th ed. 2009) ("The types of means listed in section 1123(a)(5) are clearly illustrative and not exclusive.").

[730] Section 1142(a) provides: "Notwithstanding any otherwise applicable nonbankruptcy law, rule, or regulation relating to financial condition, the debtor and any entity organized or to be organized for the purpose of carrying out the plan shall carry out the plan and shall comply with any orders of the court." 11 U.S.C. § 1142(a).

[731] *In re* Pac. Gas & Elec. Co. v. Cal. Dep't of Toxic Substances Control, 350 F.3d 932, 949 (9th Cir. 2003), *cert. denied*, 543 U.S. 956 (2004).

[732] *In re* Renegade Holdings, Inc., 429 B.R. 502 (Bankr. M.D.N.C. 2010) (declining to follow *Pacific Gas*). *See also In re* Federal Mogul Global Inc., 684 F.3d 355 (3d Cir. 2012) (same); *In re* FCX, Inc., 853 F.2d 1149, 1155 (4th Cir. 1988), *cert. denied*, 489 U.S. 1011 (1989) (holding that section 1123(a)(5) is an "empowering statute" that

b. Preemption and the Authority to Approve Transactions and Plan: Recommendations and Findings

State entity governance law continues to play an important role in the debtor's operations post-petition and postconfirmation. In light of the Bankruptcy Clause of the U.S. Constitution[733] and well-established principles of federal preemption, however, there are instances in which state entity governance law and other related law must yield to the Bankruptcy Code. The Commission endeavored to clarify these boundaries and better articulate the debtor in possession's ability to transact business during the chapter 11 case.

The Commissioners discussed areas of the federal bankruptcy law and state entity governance law that might conflict, focusing on sale transactions, plan implementation, and equity security holders meetings. The Commissioners found that courts generally allow debtors in possession to proceed with section 363 sales of all or substantially of its assets without any equity security holder approval under applicable state law or the debtor's organizational documents. The Commissioners discussed the protections for stakeholders provided by the Bankruptcy Code in the sale context, including the new principles proposed for section 363x sales. They also considered the delay and uncertainty introduced into the process by requiring an equity security holders' vote, the fact that equity security holders are often out of the money in these cases, and the ability of equity security holders to object or otherwise be heard on the proposed sale under sections 1109 and 363 of the Bankruptcy Code. The Commission agreed that the Bankruptcy Code should be amended to clarify the ability of the board of directors or similar governing body to pursue and consummate section 363 transactions without approvals required by state entity governance law, including an equity security holders' vote.

The Commissioners also discussed the different approaches of courts to a debtor in possession's obligations under state law to hold annual or special shareholders' meetings. The Commissioners recognized that complying with an annual meeting requirement, or responding to a shareholder's request for a special meeting, may impose costs on the estate and delay the case. They did not believe, however, that a general prohibition on shareholders' meetings during chapter 11 cases was an appropriate response. When the debtor acting as such for the benefit of its shareholders (as opposed to the debtor in possession acting as representative of the estate; see next section) may propose a plan, it may be inappropriate to deny the shareholders the right to elect the directors who are representing the shareholders' interests. The Commission determined that this issue was best resolved by courts under the current law and the facts of the particular case.

"does not simply provide a means to exercise the debtor's pre-Bankruptcy rights; it enlarges the scope of those rights"); *In re* Stone & Webster, Inc., 286 B.R. 532, 543 (Bankr. D. Del. 2002) (explaining that "the provisions of a plan as articulated in § 1123(a) can be effected without regard to otherwise applicable nonbankruptcy law, including the corporation law of the State of Delaware or any other state corporation laws having bearing on the debtors").

[733] U.S. Const. art. I, § 8, cl.4.

In addition, the Commissioners discussed the interplay of bankruptcy law and applicable nonbankruptcy law in the context of transactions necessary to implement, or contemplated by, a chapter 11 plan. The Commission reviewed the case law on the scope and application of section 1123(a), and along with 1984 amendment suggesting that Congress was expressly preempting nonbankruptcy law in that particular context. Indeed, "notwithstanding" is one of the most common indicators of expressed preemption, discarding any need to consider whether implied preemption was intended. The Commission considered whether there was a justification for linking the section 1123(a) preemption to the more limited preemption suggested in the section 1142(a) context. Notably, section 1123(a) speaks to matters necessary to obtain confirmation of the plan and to then implement the transactions, transfers, and distributions contemplated in the confirmed plan. The Commission agreed with those courts interpreting section 1123(a) as an empowering statute and recommended that sections 1141 and 1142 be amended to clarify the preemptive effect of that section.

2. Role of Debtor in Plan Process

Recommended Principles:

- Section 1121 of the Bankruptcy Code should be amended to clarify that a debtor, in its capacity as such and as a plan proponent, is required to comply only with its fiduciary duties under applicable state entity governance law in negotiating, drafting, and seeking confirmation of a chapter 11 plan.
- Section 1121 should be amended to clarify that a debtor in possession's board of directors, officers, or similar managing persons act as fiduciaries for the debtor in connection with the plan process (including, but not limited to, formulation, confirmation, and consummation of the plan), and applicable state law fiduciary duties should continue to govern their conduct.
- In addition, to foster efficient and effective representation, professionals for the debtor in possession should be able to represent the debtor in possession in its capacity as an estate fiduciary and in its separate capacity as a debtor and plan proponent without violating section 327. Accordingly, section 327 should be amended to clarify this point.
- For a discussion of the fiduciary duties of the debtor in possession's board of directors, officers, or similar managing persons, see Section IV.A.1, *The Debtor in Possession Model*.

a. Role of Debtor in Plan Process: Background

When a company files a chapter 11 case, it assumes the role of debtor in possession, which has certain rights, powers, and duties different from the pre-petition debtor. Specifically, under section 1107 of the Bankruptcy Code, the debtor in possession has the rights, powers, and duties of a bankruptcy trustee. The debtor in possession is also a fiduciary for the estate. Most provisions of the Bankruptcy Code relevant to a chapter 11 case authorize the trustee, and in turn the debtor in possession,

to take certain actions and exercise certain rights.[734] Other provisions that require disclosures, impose obligations, or concern creditors' rights in the case tend to apply to, or reference, the debtor. One important exception to this general categorical divide is section 1121 of the Bankruptcy Code, which provides that "[t]he debtor may file a plan with a petition commencing a voluntary case, or at any time in a voluntary case or an involuntary case." Moreover, "only the debtor may file a plan until the 120 days after" the petition date.

The legislative history of section 1121 focuses primarily on mitigating the practices under Chapter XI of the Bankruptcy Act that did not allow nondebtor parties to submit a plan of reorganization.[735] Congress was concerned that complete exclusivity in the plan context might hold creditors hostage and subject them to unfavorable treatment in the plan.[736] Nevertheless, Congress recognized that the debtor was in the best position to serve as an honest broker and to negotiate a consensual plan. There is some suggestion that Congress was also concerned with providing appropriate incentives for pre-petition management to invoke chapter 11 and to use the plan process to rehabilitate the debtor's business.

Although the company's directors and officers remain the same whether it is serving as the debtor or the debtor in possession, the Bankruptcy Code arguably contemplates different roles for these two entities. Some courts interpret the language of the Bankruptcy Code as endorsing this approach, and they treat the debtor and the debtor's fiduciary duties differently than those of the debtor in possession. For example, the court in *In re Water's Edge* determined that the debtor in possession, acting as the

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[734] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[735] One court cited the legislative history of the Bankruptcy Act in support of creditor involvement:

> Within certain limits, the Chapter XI debtor can effectively dictate the essential ingredients of a Chapter XI plan to its creditors. In many cases, the alternative to creditors may be to accept the proverbial 'ten cents on the dollar' offered or be confronted with an adjudication in bankruptcy and the resultant liquidation. . . . The substantial loss that may be faced by creditors as a consequence of the forced auction sale of work in process, inventory, machinery and plant may be overwhelming. . . . The take-it-or-leave-it attitude on the part of debtors as permitted by Chapter XI is fraught with potential abuse. The granting of authority to creditors to propose plans of reorganization and rehabilitation serves to eliminate the potential harm and disadvantages to creditors [and] democratizes the reorganization process.

In re Lake in the Woods, 10 B.R. 338, 344 (E.D. Mich. 1981) (quoting Bankr. Act Revision, Serial No. 27, Part 3, Hearings on H.R. 31 and H.R. 32 before the Subcomm. on Civil and Constitutional Rights of the Comm. on the Judiciary, 94th Cong., 2d Sess., at 1875–76 (Mar. 29, 1976) (statement of H. Miller, W. Rochelle and J. Trost)).

[736] The Fifth Circuit explained the imbalance between debtors and their creditors that section 1121 was designed to mitigate:

> While we are not called upon here to decide what factors constitute "cause" for the extension of the exclusivity period, we think that any bankruptcy court involved in an assessment of whether "cause" exists should be mindful of the legislative goal behind Section 1121. The bankruptcy court must avoid reinstituting the imbalance between the debtor and its creditors that characterized proceedings under the old Chapter XI. Section 1121 was designed, and should be faithfully interpreted, to limit the delay that makes creditors the hostages of Chapter 11 debtors.

United Sav. Ass'n v. Timbers of Inwood Forest Assocs., Ltd. (*In re* Timbers of Inwood Forest Assocs., Ltd.), 808 F.2d 363, 372 (5th Cir. 1987), *aff 'd*, 484 U.S. 365 (1988).

debtor and plan proponent under sections 1121, 1127, 1129, 1141, and 1142, had no fiduciary duties to the estate.[737] The court explained:

> A debtor in possession [as a debtor/plan proponent] is therefore permitted to place its own interests above those of the unsecured creditors with respect to what it proposes to pay under its plan. This is of course inconsistent with the concept that the debtor in possession is a fiduciary of the unsecured creditors owing them a duty of loyalty. The conclusion seems inescapable. As to its proposed plan dividend, a debtor in possession is not a fiduciary of the unsecured creditors owing them a duty of loyalty. Its bargaining and cramdown rights necessarily exclude such a fiduciary obligation.[738]

Other courts are imprecise in discussing the debtor's or debtor in possession's roles in the plan process, and some have determined that the debtor in possession continues to owe duties to the estate in formulating and filing a plan. In addition, this confusion often spills over to the role and duties of the debtor in possession's professionals.[739]

b. Role of Debtor in Plan Process: Recommendations and Findings

Under section 1121 of the Bankruptcy Code, the debtor, as distinct from the debtor in possession, may file a chapter 11 plan. This distinction is important given the often competing and conflicting interests present in the bankruptcy estate and the challenges that a debtor would face if required to negotiate and draft a chapter 11 plan that satisfied some fiduciary duty to these competing stakeholders.[740]

The Commission considered the continued utility of the distinction between the debtor and the debtor in possession in the plan process context. The Commissioners observed that the debtor as a plan proponent must consider the interests of the company and the company's obligations to creditors and equity security holders in developing its chapter 11 plan. In this capacity, the debtor may be called upon to make difficult decisions concerning the business, its workforce, its assets, and its relationships with stakeholders. Although the debtor will negotiate with key stakeholders and attempt to achieve a consensus on its plan, it may not be able to start (or end) those negotiations with a plan structure that primarily benefits creditors alone. Moreover, what is in the best interests of creditors may not necessarily be in the best long-term interests of the company or its equity security holders in the plan context.

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[737] *In re* Water's Edge Ltd. P'ship, 251 B.R. 1, 7 (Bankr. D. Mass. 2000).

[738] *Id.* at 8.

[739] *See, e.g.*, Hansen, Jones & Leta, P.C. v. Segal, 220 B.R. 434, 459–60 (D. Utah 1998).

[740] *See, e.g.*, *Written Statement of Thomas J. Salerno: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 5 (Nov. 7, 2013) ("[C]ertain provisions of the Bankruptcy Code related to the plan negotiation process appear inconsistent with imposition of a duty of loyalty to creditors of the estate occurring in plan negotiations. In light of these provisions, and the sheer impossibility of absolute loyalty to two adverse interests in the negotiating process, it appears that directors and officers are not held, and should not be held, to the same fiduciary duty of loyalty to the estate in the negotiation of a plan."), *available at* Commission website, *supra* note 55.

The Commissioners analyzed whether it would be feasible for a debtor in possession to serve multiple masters by acting as a fiduciary for equity security holders and creditors in the plan process. The Commissioners discussed the potential conflicts of interests and competing objectives that could paralyze a debtor in possession acting in this dual role. A debtor in possession should not be placed in the position of negotiating a plan for the company and its equity security holders with the creditors whose interests the debtor in possession represents as a fiduciary of the estate. A party negotiating on behalf of different parties in the same deal rarely produces the best or a fair result. Accordingly, the Commission agreed that the debtor should be separated from the debtor in possession in the plan context, and that the debtor acting as plan proponent should not be considered a fiduciary for the creditors.

The Commissioners then discussed what fiduciary duties, if any, the debtor's directors, officers, or similar managing persons should owe in the plan process. They reviewed a proposal by Stephen Case that would allow the debtor to select the beneficiary for its duties — e.g., shareholders, creditors, etc.[741] Although that approach would provide certainty to the process, the Commissioners expressed concerns about strategic maneuvers, collusion, and conflicts with state entity governance law. As such, the Commissioners found that the most efficient approach would be to impose whatever duties applicable state entity governance law would impose in these circumstances. This approach also would be consistent with other duty-related principles discussed by the Commission. In addition, the Commission agreed that professionals for the debtor in possession should not be disqualified from representing the debtor in the plan process solely on the basis that such professionals were representing the debtor in two different capacities. The Commissioners acknowledged that requiring separate professionals would impose unnecessary and likely duplicative costs on the estate with no real advantages, provided that the professionals otherwise were disinterested and satisfied section 327 or 328 of the Bankruptcy Code.

B. Approval of Section 363x Sales

Recommended Principles:

- The court should approve a sale of all or substantially all of a debtor's assets only if the court finds by a preponderance of the evidence that the proposed sale is in the best interests of the estate and satisfies the following requirements:
  - The sale complies with the applicable provisions of the Bankruptcy Code. (Comparable plan provision found at 11 U.S.C. § 1129(a)(1).)
  - The proponent of the sale complies with the applicable provisions of the Bankruptcy Code. (Comparable plan provision found at 11 U.S.C. § 1129(a)(2).)

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[741] *See* Stephen H. Case, *Fiduciary Duty of Corporate Directors and Officers, Resolution of Conflicts Between Creditors and Shareholders, and Removal of Directors by Dissident Shareholders in Chapter 11 Cases* 13, in C371 A.L.I.-A.B.A. 1, 17 (Study Materials for A.L.I.-A.B.A.'s Williamsburg Conference on Bankruptcy, Oct. 17–19, 1988) (explaining that the duty of impartiality imposed on directors of a debtor in possession should permit those directors to elect to act in a pro-creditor, pro-equity, or stakeholder mediator capacity).

o The sale has been proposed in good faith and not by any means forbidden by law. (Comparable plan provision found at 11 U.S.C. § 1129(a)(3).)

o Any payment made or to be made by the debtor or by a person acquiring property in the sale for services or for costs and expenses in or in connection with the case, or in connection with the sale and incident to the case, has been approved by, or is subject to the approval of, the court as reasonable. (Comparable plan provision found at 11 U.S.C. § 1129(a)(4).)

o Except to the extent that the holder of a particular claim has agreed to a different treatment of such claim, the trustee proposes to use or reserve sufficient proceeds from the sale to satisfy in full allowed claims of a kind specified in section 507(a)(2) or (3) incurred through the date of the closing of the sale. (Comparable plan provision found at 11 U.S.C. § 1129(a)(9)(A).)

o All fees payable under section 1930 of title 28 of the U.S. Code, as determined by the court at the hearing on the sale, have been paid or the trustee provides for the payment of all such fees on the date of the closing of the sale. (Comparable plan provision found at 11 U.S.C. § 1129(a)(12).)

o The trustee has provided adequate notice and an opportunity to be heard to all creditors and equity security holders who may be affected by a release or discharge that provides claims protection for the purchaser in the order approving the sale.

• A section 363x sale is subject to the principles on orders resolving chapter 11 cases. See Section VI.G, *Orders Resolving Chapter 11 Case (Exit Orders)*.

• These principles refer to "a sale of all or substantially all of a debtor's assets" as a "section 363x sale." For the timing of section 363x sales, see Section IV.C.2, *Timing of Section 363x Sales*.

• The other recommended principles relating to transactions outside the ordinary course also apply in the section 363x sale context. See Section V.B, *Use, Sale, or Lease of Property of the Estate*.

a. Approval of Section 363x Sales: Background

As explained above, a debtor in possession[742] may seek to sell all or substantially all of its assets under section 363(b) of the Bankruptcy Code.[743] This kind of sale (referred to in these principles as a "section 363x sale") is a value realization event in the chapter 11 case, as it involves monetizing nearly all of the assets available to satisfy claims against and interests in the estate. Because a section 363x sale terminates the

[742] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[743] *See* Section V.B, *Use, Sale, or Lease of Property of the Estate*. *See also* George W. Kuney, *Let's Make It Official: Adding an Explicit Preplan Sale Process as an Alternative Exit from Bankruptcy*, 40 Hous. L. Rev. 1265, 1267–68 (2004) (discussing increasing use of chapter 11 to sell assets).

estate's and, in turn, creditors' interests in the assets, the process to facilitate such a sale is critically important to the recoveries ultimately received by creditors. The timing of a section 363 sale can significantly impact value and raises notice and due process concerns; timing issues are addressed separately above.[744]

A section 363x sale transforms the estate from illiquid assets with fluctuating value to a fixed sum of money or securities.[745] Consequently, it potentially alters the value of the estate in a positive or negative direction, depending on factors such as the timing of the sale, the marketing of the assets, the competitive nature of the auction, and the sale and restructuring alternatives explored by the debtor in possession leading up to the section 363x sale. Anecdotal evidence suggests that section 363x sales can facilitate quicker sales that create value for the estate.[746] Such evidence also suggests, however, that a bidder may pursue certain strategies such as a "loan-to-own" strategy or streamlined sale process that may chill bidding and depress the value of the assets.[747]

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[744] *See* Section IV.C.2, *Timing of Section 363x Sales*.

[745] *See Written Statement of Maureen Leary: SABA/NAAG Annual Seminar Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 8, 2013) (describing the potential negative consequences to creditors and, in turn, problems with sales of substantially all of a debtor's assets under section 363), *available at* Commission website, *supra* note 55.

[746] For a thorough discussion of the competing perspectives on section 363 sales of all or substantially all of a debtor's assets in chapter 11, *see In re* Gulf Coast Oil Corp., 404 B.R. 407, 419 (Bankr. S.D. Tex. 2009) (reviewing the relevant case law, treatises, and academic literature). *See also* Stuart Gilson, *Coming Through in a Crisis: How Chapter 11 and the Debt Restructuring Industry Are Helping to Revive the U.S. Economy*, 24 J. Applied Corp. Fin. 23 (2012) ("Increasingly, distressed companies have also taken advantage of Chapter 11 as a more efficient way to sell assets."); Jared A. Wilkerson, *Defending the Current State of Section 363 Sales*, 86 Am. Bankr. L.J. 591 (2012) (refuting criticism of section 363 sales in chapter 11 and highlighting potential efficiencies of such sales). *See generally* Section IV.C.2, *Timing of Section 363x Sales*.

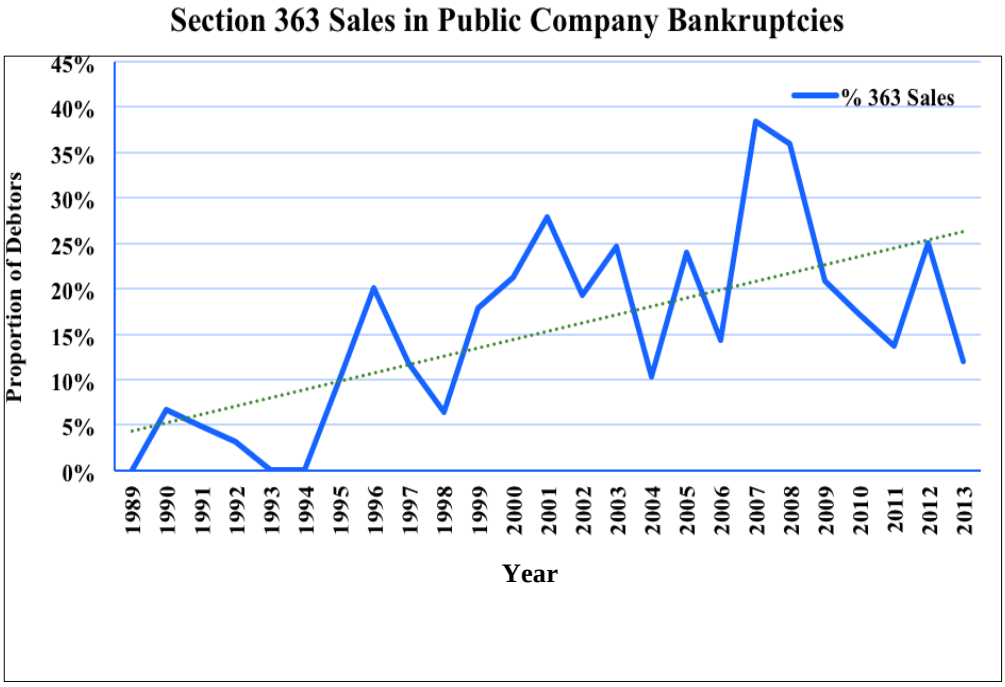
[747] *See, e.g.*, Michelle M. Harner, *Trends in Distressed Debt Investing: An Empirical Study of Investors Objectives*, 16 Am. Bankr. Inst. L. Rev. 69 (2008) (reporting results of empirical survey on, among other issues, investors' loan-to-own strategies in bankruptcy). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies). *See also* Jonathan M. Landers, *Reflections on Loan-to-Own Trends*, Am. Bankr. Inst. J., Oct. 2007, at 44–46 (explaining loan-to-own transactions); Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511, 513 (2009) (discussing, among other things, impact of creditor control on the decision to sell assets in bankruptcy); Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115 ("Controlling secured lenders often use chapter 11 as a vehicle to foreclose on their assets. Traditional corporate reorganizations are becoming a *rara avis*; the strongly emerging norm is for debtors to be liquidated in speedy '§ 363 sales,' the reference being to the Bankruptcy Code section authorizing sales. This practice has become so prevalent that a coauthor and I have spoken of the 'new 'Chapter 3' reorganization.'"); Brubaker, *Credit Bidding and the Secured Creditor's Baseline Distributional Entitlement in Chapter 11*, *supra* note 542, at 10 ("The 'loan to own' phenomenon has caused some to question the advisability of credit bidding. The basic concern seems to be that a 'loan to own' lender's primary incentive is, unlike a traditional lender, acquiring the debtor's assets as cheaply as possible, rather than maximizing the recovery on its secured loan. A traditional lender has every incentive to maximize the sale price of its collateral through vigorous competitive bidding, sincerely hoping that bid prices will exceed the amount it could credit bid with its existing secured loan, as this would mean a full recovery on that loan. A 'loan to own' lender, though, has every incentive to inhibit competitive bidding in order to ensure that bid prices will not exceed the amount it can credit bid with its existing secured loan, as this would mean that the 'loan to own' lender can acquire the debtor's assets solely through a credit bid of its existing secured loan and with no additional investment."); Jay Lawrence Westbrook, *The Control of Wealth in Bankruptcy*, 82 Tex. L. Rev. 795, 846 (2004) ("In both judicial and private auction sales, there are often strict requirements for a bidder other than the secured party. In particular, the bidder may have to bring sufficient cash to cover its bid or to provide cash payment very shortly after the bidding. For this and other reasons, it is often the case that few other bidders appear at foreclosure and repossession sales. This fact combines with the bidding-in rules to make it possible for secured parties to buy at their own sales at a price well below market value while avoiding sanctions for violating Article 9's notice and sale procedures.").

The limited empirical data on section 363x sales are mixed in results and difficult to interpret because the coding of the debtor's exit strategy as a liquidation, going concern sale (i.e., section 363x sale), or confirmed plan often is very subjective, and the data are "noisy" in this respect.[748] It also is challenging for empiricists to collect and code creditors' recoveries, particularly in cases that do not have publicly traded securities. In fact, much of the data on chapter 11 cases speak only to the large chapter 11 cases.[749] For example, the chart shown below demonstrates a positive linear trend (illustrated by the dotted line) in the number of section 363 sales in chapter 11 cases, but it also is limited to large public companies.[750]

[748] *See, e.g.*, Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Fire Sales*, 106 Mich. L. Rev. 1 (2007) (study analyzing large public company bankruptcy cases and finding that recoveries in reorganization cases are more than double recoveries from going concern sales); James J. White, *Bankruptcy Noir*, 106 Mich. L. Rev. 691 (2007) (critiquing the LoPucki & Doherty study and finding no statistical difference between sale prices and reorganization prices); Lynn M. LoPucki & Joseph W. Doherty, *Bankruptcy Verite*, 106 Mich. L. Rev. 721 (2008) (responding to the White study). *See also, e.g.*, Jenkins & Smith, *Creditor Conflict and the Efficiency of Corporate Reorganization*, *supra* note 42 (developing model to assess efficient and inefficient liquidations in bankruptcy and concluding that about 8 percent of firms are inefficiently liquidated — *i.e.*, they were liquidated when it would have been more efficient to reorganize); Edith S. Hotchkiss & Robert M. Mooradian, *Acquisitions as a Means of Restructuring Firms in Chapter 11*, 7 J. Fin. Intermediation, 240–262 (1998) (providing "empirical evidence that takeovers can facilitate the efficient redeployment of assets of bankruptcy firms"). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[749] For example, many chapter 11 empirical studies use the UCLA-LoPucki Bankruptcy Research Database or a similarly restricted database. The UCLA-LoPucki Bankruptcy Research Database includes all bankruptcy cases filed between 1980 and 2012 by or against a business debtor or group of affiliated debtors that had assets worth $100 million or more, measured in 1980 dollars.

[750] Mr. Shrestha prepared this chart for the Commission based on data from the UCLA-LoPucki Bankruptcy Research Database. Accordingly, it was limited to large public companies. The chart analyzes all Section 363 Sales in the UCLA-LoPucki Bankruptcy Research Database (including confirmed, pending, converted, and dismissed cases). Because certain of the cases included in this analysis did not include data for the date of the sale order, some of these data are not included in the chart describing the median duration between the petition date and sale order date in bankruptcy cases. *See* Section IV.C.2, *Timing of Section 363x Sales. But see* Jay Lawrence Westbrook, *The Role of Secured Credit in Chapter 11 Cases: An Empirical Review*, 2015 Ill. L. Rev. , at *6 (forthcoming 2015) (finding, in an empirical study of 424 cases covering a broad cross section of chapter 11 debtors in nine districts, that only about 25 percent of cases and any sales out of the ordinary course, suggesting that section 363 sales are less common that previously thought) (draft on file with Commission). *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).



Moreover, chapter 11 cases — unlike consumer bankruptcy cases — often present unique facts and involve dynamics not reflected on the court docket. Accordingly, although the data are extremely informative, they should be read with caution, and any claims of causality should be critically analyzed given the foregoing factors and related research limitations (e.g., endogeneity bias, sample selection bias) that may impact research issues in this area.[751]

As suggested above, a section 363x basically determines the maximum recovery any particular creditor will receive in the case. In a case where the debtor's assets are sold for less than the value of the secured claims asserted against the estate, junior creditors — including those holding pre-petition unsecured claims and, potentially, post-petition administrative claims relating to the administration of the case following the sale — may not receive any distributions. Although a debtor that liquidates in chapter 11 does not receive a discharge, for all practical purposes, a section 363x essentially discharges the primary source of recovery in business cases (i.e., the debtor's assets).

Accordingly, many courts raise concerns regarding section 363x sales in chapter 11 cases. Among other things, courts and commentators note that these sales skirt the notice and due process protections of the plan process, are often pursued before parties in interest have adequate information to assess the sale and a debtor's restructuring alternatives, and may determine ultimate distributions to creditors without creditors

[751] *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

having a vote or the protections of the "fair and equitable" standard of section 1129(b).[752] Nevertheless, as many of these courts recognize, a debtor in possession may have no viable restructuring alternatives, and the section 363x sale may in fact represent its best opportunity for providing recoveries to at least some stakeholders. In these circumstances, many courts strive to make a going concern sale work under the current Bankruptcy Code, but it was not an intended, and thus is not a perfect, fit.[753]

b. Approval of Section 363x Sales: Recommendations and Findings

Some commentators argue that a sale of all or substantially all of a debtor's assets is akin to a traditional reorganization in that it is a change-of-control event that facilitates distributions of value to creditors and frequently continues the business of the debtor in some form. The Commissioners debated this general proposition at length. Although the Commissioners held differing views on what qualifies as "reorganization" under chapter 11, many of the Commissioners believed that sales of all or substantially all of a debtor's assets have become part of the restructuring landscape. As such, the Commission agreed that the most constructive approach to the issue was to analyze critically the sale process, recognizing the potential utility of the process in achieving certain policy goals, including maximizing value for creditors and preserving jobs for at least part of the debtor's workforce.

As discussed above, a key concern among the Commissioners was the timing of section 363x sales, which they believed should be conducted in a methodical manner and on a reasonable timeline so that the debtor can identify, and creditors can confirm, that the sale not only provides the best and highest offer for the assets, but also the best restructuring alternative for the debtor and all of its stakeholders. The Commission recommended a 60-day moratorium on section 363x sales to promote these objectives.[754]

The Commissioners reflected on the meaningful differences between a section 363x sale process and the chapter 11 plan process. They considered both substantive and procedural aspects of the process. For example, courts use slightly different standards of review in approving sales of substantially all of a debtor's assets under section 363 of the Bankruptcy Code.[755] Most courts employ some form of heightened scrutiny, but that

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[752] *See, e.g.*, *In re* Gen. Motors Corp., 407 B.R. 463, 491 (Bankr. S.D.N.Y. 2009), *aff 'd*, *In re* Motors Liquidation Co., 430 B.R. 65 (S.D.N.Y. 2010) ("[A] debtor cannot enter into a transaction that 'would amount to a *sub rosa* plan of reorganization' or an attempt to circumvent the chapter 11 requirements for confirmation of a plan of reorganization."). *But see* Comm. of Equity Sec. Holders v. Lionel Corp.(*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) ("Every sale under § 363(b) does not automatically short-circuit or side-step Chapter 11; nor are these two statutory provisions to be read as mutually exclusive. Instead, if a bankruptcy judge is to administer a business reorganization successfully under the Code, then . . . some play for the operation of both § 363(b) and Chapter 11 must be allowed for.").

[753] *See, e.g.*, *In re* Chrysler LLC, 405 B.R. 84, 96 (Bankr. S.D.N.Y. 2009), *appeal dismissed*, 592 F.3d 370 (2d Cir. 2010) ("A debtor may sell substantially all of its assets as a going concern and later submit a plan of liquidation providing for the distribution of the proceeds of the sale. This strategy is employed, for example, when there is a need to preserve the going concern value because revenues are not sufficient to support the continued operation of the business and there are no viable sources for financing.").

[754] *See* Section IV.C.2, *Timing of Section 363x Sales*.

[755] *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1072 (2d Cir. 1983) (reviewing historical standard applicable to bankruptcy sales and finding more flexibility under section 363(b), noting that "[i]n fashioning its findings, a bankruptcy judge must not blindly follow the hue and cry of the most

review may simply turn on whether the debtor in possession has a "good reason" for the proposed sale under the circumstances of the particular case.[756] Such a standard is a much different and arguably lower standard than that applied to confirmation of a chapter 11 plan in the cramdown context.[757] The Commissioners observed that a cramdown analysis generally is applicable because most classes of creditors will be impaired by the sale and receive nominal, if any, distributions from the sale proceeds. Moreover, creditors do not get a "vote" on the sale. To confirm a plan under the section 1129 cramdown standard, a debtor must establish that the plan (i) satisfies all of the requirements of section 1129(a) (including good faith, the best interests of creditors test, and payment of all administrative claims and certain priority claims), except section

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vocal special interest groups; rather, he should consider all salient factors pertaining to the proceeding and, accordingly, act to further the diverse interests of the debtor, creditors and equity holders, alike"). *See also In re* Whitehall Jewelers Holdings, Inc., 2008 WL 2951974, at *6 (Bankr. D. Del. July 28, 2008) ("[W]hen a preconfirmation [section] 363(b) sale is of all, or substantially all, of the Debtor's property, and is proposed during the beginning stages of the case, the sale transaction should be 'closely scrutinized, and the proponent bears a heightened burden of proving the elements necessary for authorization'") (citation omitted); *In re* George Walsh Chevrolet, Inc., 118 B.R. 99, 101 (Bankr. E.D. Mo. 1990) ("A sale of substantially all of the Debtor's assets other than in the ordinary course of business and without the structure of a Chapter 11 Disclosure Statement and Plan . . . must be closely scrutinized and the proponent bears a heightened burden of proving the elements necessary for authorization."); *In re* Indus. Valley Refrigeration & Air Conditioning Supplies, Inc., 77 B.R. 15, 17 (Bankr. E.D. Pa. 1987) (holding that a sale of virtually all of the debtor's assets "can be permitted only when a good business reason for conducting a preconfirmation sale is established and . . . the burden of proving the elements for approval of any sale out of the ordinary course of business — including provision of proper notice, adequacy of price, and 'good faith' — is heightened").

[756] *See* Comm. of Equity Sec. Holders v. Lionel Corp. (*In re* Lionel Corp.), 722 F.2d 1063, 1071 (2d Cir. 1983) ("The rule we adopt requires that a judge determining a § 363(b) application expressly find from the evidence presented before him at the hearing a good business reason to grant such an application."). *See also In re* Boston Generating, LLC, 440 B.R. 302, 321 (Bankr. S.D.N.Y. 2010) ("[A] court rendering a section 363(b) determination must 'expressly find from the evidence presented . . . a good business reason to grant such application.'") (citations omitted); *In re* Daufuskie Island Props., LLC, 431 B.R. 626, 637 (Bankr. D.S.C. 2010) ("(Because the sale is one of substantially all assets of the Estate prior to confirmation of a Chapter 11 plan in this case, authorization for the sale under § 363(b)(1) requires that the Trustee satisfy the 'sound business purpose' test for pre-confirmation sales."); *In re* Gen. Motors Corp., 407 B.R. 463, 489 (Bankr. S.D.N.Y. 2009), *aff 'd*, *In re* Motors Liquidation Co., 430 B.R. 65 (S.D.N.Y. 2010) ("[I]t is plain that in the Second Circuit, as elsewhere, even the entirety of a debtor's business may be sold without waiting for confirmation when there is a good business reason for doing so."); *In re* Nicole Energy Servs., Inc., 385 B.R. 201, 10 (Bankr. S.D. Ohio 2008) ("[T]he Court may approve a sale of all of a debtor's assets under § 363(b) 'when a sound business purpose dictates such action.'").

[757] *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 16–17 (Nov. 15, 2012) ("Chapter 11 plans of liquidation continue to grow in popularity as a 'reorganization' option but offer less protection to creditors, including secured creditors, than a liquidation under Chapter 7. In almost all cases, once the Chapter 11 plan of liquidation has been confirmed, it is the debtor or liquidating trustee who conducts the liquidation without further input from creditors and often with limited (if any) judicial oversight. As a result, creditors have little or no input into the liquidation decisions made by the liquidating trustee/debtor beyond the information contained in the disclosure statement, and there is no real ability on the part of creditors to oversee the liquidation that is being accomplished — allegedly for their benefit. . . . It is becoming commonplace that courts will not condone a §363 sale which disposes of substantially all of the estate's assets without the court and the creditors being advised as to the terms of 'wind-down' or a plan of liquidation. Similarly, many courts allow for what are referred to as "structured dismissals" in lieu of either a Chapter 11 plan of liquidation or a conversion to Chapter 7, without any specific statutory underpinning. Without giving any real guidance as to when a Chapter 11 liquidation is appropriate and the level of interaction available to creditors if the Debtor has not complied with the plan or refuses to cooperate, the secured lender is left only with the option of reclaiming its collateral."), *available at* Commission website, *supra* note 55; *See Written Statement of Maureen Leary: SABA/NAAG Annual Seminar Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 8, 2013) (suggesting higher standard of review for sales under section 363(b) and (f)), *available at* Commission website, *supra* note 55.

1129(a)(8); and (ii) does not discriminate unfairly and is fair and equitable with respect to each dissenting impaired class under section 1129(b).[758]

In general, a plan discriminates unfairly against an impaired dissenting class if it provides greater value to a class of claims or interests with equal priority. "In a nutshell, if the plan protects the legal rights of a dissenting class in a manner consistent with the treatment of other classes whose legal rights are intertwined with those of the dissenting class, then the plan does not discriminate unfairly with respect to the dissenting class."[759] Section 1129(b)(2) sets forth certain standards that must be met for the plan to be considered fair and equitable as to dissenting impaired classes of secured and unsecured claims and equity interests. The legislative history, however, also makes clear that certain factors that are relevant to the fair and equitable determination are not specified in section 1129.[760] The most common factor considered in this context is a prohibition on a senior class receiving more than 100 percent of its claim in a cramdown scenario.

In addition to substantive distinctions, the Commissioners observed that, particularly in an expedited sale process, many creditors do not receive notice of the sale or sufficient information to evaluate the sale. Yet the sale may eviscerate any recoveries for unsecured creditors in the case, and could subject some or all of the creditors to third-party releases or discharges that impact the parties and property potentially available to satisfy their claims. The Commissioners believed that more meaningful notice to a broader audience is necessary and appropriate in many cases.

Overall, the Commissioners found little difference in the consequences to creditors' rights and claims under an order approving a section 363x sale or an order confirming a chapter 11 plan. They did find, however, significant differences in the creditor protections available under the two processes. Considering the potentially greater exposure to loss of value in the sale context where the assets are being removed from the estate, the Commission ultimately determined that creditors should be afforded at least the same level of protection in the section 363x sale process and in the chapter 11 plan process. The proposed procedural principles for section 363x incorporate these recommendations.

C. Value Determinations, Allocation, and Distributions

1. Creditors' Rights to Reorganization Value and Redemption Option Value

Recommended Principles:

- A class of senior creditors should be entitled to receive in respect of their secured claims distributions under the chapter 11 plan or order approving a section 363x sale having a value equal to the reorganization value (or portion thereof) attributable to the collateral securing their claims as of the effective date of the plan or the date of a section 363x sale order, unless such classes

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[758] 11 U.S.C. § 1129(a), (b).

[759] Kenneth N. Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L.J. 133, 142 (1979).

[760] *Id.*

agree to accept different treatment. For purposes of this principle, the term "reorganization value" means (i) if the debtor is reorganizing under the plan, the enterprise value attributable to the reorganized business entity, plus the net realizable value of its assets that are not included in determining the enterprise value and are subject to subsequent disposition as provided in the confirmed plan; or (ii) if the debtor is selling all or substantially all of its assets under section 363x or a chapter 11 plan, the net sale price for the enterprise plus the net realizable value of its assets that are not included in such sale and are subject to subsequent disposition as provided in the confirmed plan or as contemplated at the time of the section 363x sale.[761]

- The valuation date set by the effective date of a plan or the date of a section 363x sale order should not foreclose, in appropriate cases, a distribution in the chapter 11 case on account of the possibility of future appreciation in the firm's value due to the firm's continuation as a going concern. Although the valuation at any point in time will necessarily reflect the debtor's future potential, the valuation may occur during a trough in the debtor's business cycle or the economy as a whole, and relying on a valuation at such a time may result in a reallocation of the reorganized firm's future value in favor of senior stakeholders and away from junior stakeholders in a manner that is subjectively unfair and inconsistent with the Bankruptcy Code's principle of providing a breathing spell from business adversity.
- Accordingly, except in small and medium-sized enterprise cases, the general priority scheme of chapter 11 should incorporate a mechanism to determine whether distributions to stakeholders should be adjusted due to the possibility of material changes in the value of the firm within a reasonable period of time after the plan effective date or section 363x sale order date, as the case may be. This adjustment should consider whether the class immediately junior to a senior class[762] benefiting from preserving the firm's value as a going concern in connection with a chapter 11 plan or section 363x sale (the "immediately junior class") should receive an allocation of value to recognize that the future possibilities of the ongoing firm include the possibility

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[761] In the case of a sale, the reorganization value is limited to the net value actually available for distributions to creditors after any applicable reductions, expenses, or charges.

[762] For purposes of applying these principles in connection with a chapter 11 plan when there is no sale of the firm, the relevant senior stakeholders are the class or classes of senior creditors receiving the residual interests (*e.g.*, equity securities) in the firm that will benefit from the firm's appreciation after the effective date of the plan. Generally speaking, outside the sale context (whether the sale is under section 363x or pursuant to a plan), a senior class paid in cash or solely in debt securities of the reorganized firm that receives no ongoing interest in the residual value (*e.g.*, equity) of the firm would not be required to share reorganization option value, which is intended to represent an allocation of value arising from the possibility of future appreciation in the value of the reorganized firm, with a junior class. How the principles would be applied when the residual interests in the firm are allocated among several senior classes is an issue that requires further development. In the context of a sale of substantially all of the assets of the firm, whether under section 363x or pursuant to a plan, the distribution to the immediately junior class would, generally speaking, be from the senior class's or classes' otherwise-applicable entitlement to the proceeds of the sale and would be made in cash or such other consideration that allocates the redemption option value to such immediately junior class from such proceeds.

that such an immediately junior class might have been in the money or received a greater recovery if the firm had been valued at a later date.[763]

- In furtherance of this principle, except in small and medium-sized enterprise cases, an immediately junior class that might otherwise be permanently cut off from receiving value based on the reorganization value as of the effective date of the plan or the date of the section 363x sale order should be entitled to an allocation of value referred to as the "redemption option value" attributable to such class, as defined below. A distribution of redemption option value, if any, would be made to an immediately junior class to reflect the possibility that, between the plan effective date or sale order date and the third anniversary of the petition date (the "redemption period"), the value of the firm might have been sufficient to pay the senior class in full with interest and provide incremental value to such immediately junior class.[764] As explained below, the redemption option value in any given case may be negligible or non existent; it is not a percentage or fixed payment to junior creditors.
- In accordance with the above general principles, section 1129(b) should be amended to provide that, subject to the conditions described below,

  (a) a chapter 11 plan may be confirmed over the non-acceptance of the immediately junior class if and only if such immediately junior class receives not less than the redemption option value, if any, attributable to such class, and

  (b) a chapter 11 plan may be confirmed over the non-acceptance of a senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule treatment of the senior class is solely for the distribution to an immediately junior class of the redemption option value, if any, attributable to such class.
- Notwithstanding clause (a) above, however, if a chapter 11 plan is rejected by the immediately junior class and such class challenges the reorganization value used to determine such class's entitlement to redemption option value under such plan, the plan should be confirmed over the non-acceptance of such immediately junior class if (i) the court finds, based on the evidence presented at the confirmation hearing, that such reorganization value was not proposed in bad faith, and (ii) the plan satisfies, with respect to such immediately junior class, the requirements of section 1129(b) other than the requirement that reorganization option value be provided to such class.
- Similarly, except in small and medium-sized enterprise cases, section 363 should be amended to provide that, in the context of a section 363x sale, if the members of an immediately junior class do not object to the sale, the

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[763] In theory, this principle should apply to the allocation of the estate's value between senior and junior classes of creditors, whether the relative priority of their claims arises from liens, contractual subordination, or otherwise.

[764] Because redemption option value is determined based on the presumption that the senior class, including any unsecured deficiency claims of the senior class if the senior class holds secured claims, is paid in full, under this principle the deficiency claims held by the senior class generally would not be entitled to share in redemption option value even if such a deficiency claim would be otherwise included in the immediately junior class.

immediately junior class should be entitled to receive from the reorganization value attributable to such sale not less than the redemption option value, if any, attributable to such immediately junior class.[765] If, however, the immediately junior class objects to the sale, they will not be entitled to such redemption option value.

- Based on these principles, even if an impaired senior class would otherwise be entitled to the entirety of the reorganization value of the firm based on its reorganization value on the effective date of the plan or date of the section 363x sale order, the court should not confirm the plan over the non-acceptance of the immediately junior class or approve a sale under section 363x that is not objected to by members of the immediately junior class, as the case may be, unless the plan or the order approving the section 363x sale, as applicable, provides for an allocation of redemption option value to the immediately junior class to the extent of its entitlement thereto as described above.
    - The "redemption option value" attributable to such immediately junior class is the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price (as defined below) and a duration equal to the redemption period (as defined above).[766]
    - Generally speaking, the immediately junior class will be the class of stakeholders that would first derive material benefit from future increases in the reorganization value of the firm after payment in full of all senior classes receiving distributions under the plan. The immediately junior class will typically be the class immediately junior to the fulcrum security class (i.e., the most junior class in the debtor's capital structure receiving material distributions in the case and at which the firm's reorganization value is exhausted at the time of the enterprise valuation in the case). However, if under the plan the fulcrum class will receive a relatively small participation in the residual value of the firm at the current reorganization value because the bulk of such participation is allocated to other more senior classes, the fulcrum class may be the immediately junior class for these purposes.
    - Where the senior class would otherwise be entitled to the entire value of the firm, the "redemption price" of the hypothetical option would be the full face amount of the claims of the senior class,[767] including any

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[765] The Commission recognized that an individual creditor, several creditors, or the entire class could file objections to the sale. The Commission did not resolve the level of objection required, or whether an objection that was overruled by the court would preclude only that creditor's entitlement to any redemption option value.

[766] Since this principle establishes a minimum recovery for the junior class where the class members have not objected to the section 363x sale, the reorganization value is fixed at the net value realized by the estate in connection with the sale. As noted below, the junior class can still dispute how the redemption option value is being calculated for such reorganization value (by presenting evidence on other components of the redemption option value calculation, such as volatility). On the other hand, if there is no section 363x sale, the junior class may contest the reorganization value under the plan, and trigger application of the absolute priority rule by rejecting the plan and in that context the junior class could assert the right to a portion of a higher reorganization value.

[767] In more complex cases, where a single senior class is not entitled to the entire reorganization value of the firm and other classes senior to the immediately junior class are receiving distributions, the redemption price would have to be adjusted to include the claims of all of such senior classes, whether or not they are receiving residual interests in the firm or are among the classes required to share reorganization option value with the immediately junior class.

unsecured deficiency claim, plus any interest at the non-default contract rate[768] plus allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option, as though the claims remained outstanding on the date of the exercise of the option.

o A redemption period would be specified for purposes of setting the duration of the redemption option commencing on the effective date of the plan or the date of the section 363x sale order and ending on the third anniversary of the petition date.

- The court would determine the redemption option value, if any, attributable to the immediately junior class based on the evidence presented by the parties at the hearing under section 1129(b) or section 363x, as the case may be. The parties may, for example, demonstrate the existence, or lack, of any redemption option value through generally accepted market-based valuation models, including the Black-Scholes option pricing model, using reasonable assumptions based on the facts of the particular case.
- The redemption option value could be paid pursuant to the plan or section 363x sale order in the form of cash, debt, stock, warrants, or other consideration, provided that any non-cash consideration would be valued on a basis consistent with the manner in which reorganization value was determined. The form of consideration used to provide redemption option value to the immediately junior class should be subject to the election of the senior class being required to give up such value, regardless of whether such senior class has accepted the plan.
- The value distributed to the immediately junior class under these principles need not be, and in most cases likely would not be, in the form of an actual option. The requirement is that the requisite value of such an option be distributed to the immediately junior class, regardless of form.
- If an immediately junior class is not entitled to redemption option value for any of the reasons set forth above, such immediately junior class would be entitled to receive distributions only on a strict absolute priority basis under section 1129(b) as of the effective date of the plan, as under current law, and no special provision for redemption option value would have to be made for such class in accordance with the above principles.
- A senior creditor's election under section 1111(b) of the Bankruptcy Code should not dilute or otherwise affect the immediately junior class's rights to receive any redemption option value under the distribution rules set forth in this principle.
- The principles set forth above are not intended to alter the order of creditor priorities or to affect allocations within a particular class of creditors; rather, the principles speak generally to how courts should determine whether the

[768] The Commission discussed the appropriate interest rate to be used in determining the redemption option value and decided to use the non-default contract rate. Some Commissioners expressed the view that the default contract rate or a rate reflecting the risk of investing in the equity of the reorganized debtor should be used because the senior creditor is absorbing all of the downside risk inherent in such equity while sharing the upside potential.

reorganization value of the debtor or its assets is sufficient to support a distribution to the immediately junior class.

- The principles set forth above attempt to provide a conceptual framework for an adjustment to the current absolute priority rule, which often results in wasteful and time-consuming litigation over reorganization value in recognition that the determination of reorganization value has the effect of cutting off alternative distributional possibilities based on the fortuity of timing of the reorganization or sale. It is important to note, however, that the conceptual principle of allocating redemption option value to the immediately junior class requires further development to determine whether and how it should be applied in more complex contexts, for example where a senior class is entitled to less than all of the firm's enterprise value (for example where it is secured by only some of the assets of the firm), where contractual or structural subordination (rather than a lien) results in an immediately junior class, where there are multiple classes senior to the immediately junior class and not all such senior classes are receiving distributions in the form of interests in the residual value of the firm, where only part of the immediately junior class objects to a sale or challenges reorganization value under a plan, or where some enterprise value is distributable at the current enterprise valuation to an immediately junior class, but the junior class is not being paid in full.

a. Creditors' Rights to Reorganization Value and Redemption Option Value: Background

The Bankruptcy Code operates, among other things, to evaluate creditors' rights based, in part, on their state law entitlements and priorities. Commentators and practitioners frequently debate exactly what state law entitlements and priorities mean in the context of secured creditors. Exactly which secured creditors' rights can be modified? Are any of those rights inviolate? A variety of factors affect this analysis, including the secured creditors' rights under state law and the Fifth Amendment of the U.S. Constitution, and Congress's ability to "establish . . . uniform Laws on the subject of Bankruptcies throughout the United States" under the Bankruptcy Clause of the U.S. Constitution.[769]

The Fifth Amendment provides in relevant part: "No person shall be . . . deprived of life, liberty, or property, without due process of law."[770] Justice William O. Douglas notably explained that in bankruptcy, "[s]afeguards were provided to protect the rights of secured creditors, throughout the proceedings, to the extent of the value of the property. There is no constitutional claim of the creditor to more than that."[771] Commentators and practitioners have interpreted Justice Douglas's explanation in a variety of ways, with some suggesting that it means that a secured creditor is only entitled to the liquidation value of its interest in the debtor's property in bankruptcy, and others suggesting a broader meaning. Still another perspective is articulated by Prof.

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[769] U.S. Const. art. I, § 8, cl. 4.
[770] *Id.* amend. V.
[771] Wright v. Union Cent. Life Ins. Co., 311 U.S. 273, 278 (1940).

Tabb, who concludes that "a Fifth Amendment takings analysis simply is not helpful or indeed even applicable when considering the nature and scope of the protection constitutionally due to secured creditors in bankruptcy."[772]

The value of a secured creditor's interest in the debtor's interest in property is relevant at various points in the chapter 11 case. As explained above in the context of adequate protection, section 506(a) provides in relevant part that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property, and in conjunction with any hearing on such disposition or use or on a plan affecting such creditor's interest."[773] The valuation of a secured creditor's claim thus involves at least two questions, both of which can provoke litigation: What is the appropriate valuation standard for the property included in the secured creditor's collateral, and what is the appropriate standard for determining the value of the secured creditor's interest in such collateral under that standard? It also can raise a third issue concerning the appropriate valuation methodology — e.g., discounted cash flow, precedent sale transactions, and comparable company analysis.

Courts have taken different approaches to questions of valuation in chapter 11. Some courts suggest that liquidation value is always an appropriate standard for determining the value of the secured creditor's interest in collateral because the debtor is operating in bankruptcy. Other courts apply a liquidation standard when valuing claims in chapter 7, and a going concern standard in reorganizations under chapter 11 on the theory that the valuation should be based on how the collateral is being used. Still other courts struggle with whether a liquidation standard, if appropriate, should be analyzed on a forced-sale or orderly-sale basis. The uncertainty surrounding valuation issues generates both litigation and, arguably, consensual resolutions.

In the plan context, chapter 11 encourages consensual resolutions and permits parties to agree to distributions under a chapter 11 plan that may modify or otherwise affect their rights against the estate. Sections 1126 and 1129 codify this concept by providing that if the debtor proposes to impair the rights of a class of creditors or interest-holders under the plan and that impaired class accepts the plan, the proposed treatment of the claims or interests is permissible even if it provides those creditors or interest-holders with arguably less than otherwise required.[774] If an impaired class of claim or interest-holders, however, does not accept the plan, the debtor can impose the proposed treatment on the class only if the plan satisfies the cramdown provisions of section 1129(b) of the Bankruptcy Code, including the absolute priority rule.[775]

The absolute priority rule as applied under section 1129(b) in essence provides that a dissenting class of creditors must be paid in full before junior creditors or interest-holders may receive any distributions under the plan. The rule originates from the railroad equity receivership cases in the early 1900s and the U.S. Supreme Court's

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[772] Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *1 (arguing that the "Fifth Amendment Takings Clause does not and should not constrain the power of Congress to modify the substantive rights of secured creditors under the Bankruptcy Clause.").

[773] 11 U.S.C. § 506(a).

[774] *Id.* §§ 1126, 1129(a).

[775] *Id.* § 1129(a), (b). For a discussion of the "no unfair discrimination" requirement of section 1129(b), see Section VI.B, *Approval of Section 363x Sales*.

decision in *Northern Pacific Railway Co. v. Boyd*.[776] In that case, the railroad company reorganized by selling itself to bondholders and equity security holders and providing no distributions to junior creditors. The Supreme Court rejected this scheme and held that "[i]f the value of the [rail]road justified the issuance of stock exchanged for old shares, the creditors were entitled to the benefit of that value, whether it was present or prospective, for dividends or only for purposes of control."[777]

The absolute priority rule codified in section 1129(b) is a variation of the rule announced by the Supreme Court in *Boyd*, but it continues the basic tenet that priority matters — i.e., secured creditors have a right to receive payment in full prior to junior creditors and interest-holders receiving any value. Section 1129(b) also articulates an application of the absolute priority rule for secured claims, which preserves those payment rights in the waterfall payment scheme of a chapter 11 plan. As one commentator noted shortly after the enactment of the Bankruptcy Code, "the [absolute priority] test for secured claims is completely novel, affording protection for classes of secured claims that is not provided under present law."[778]

The absolute priority rule is an important creditor protection in chapter 11 cases, but it also has proven to be inflexible and often a barrier to a debtor's successful reorganization. It also can allocate value among creditors in an arguably random manner depending on the timing of the value realization event — i.e., plan confirmation. For example, to the extent that a plan is confirmed during a downturn in the economy generally or the debtor's industry more specifically, the valuations used to support the plan distributions may value the reorganized entity at a low point in the valuation cycle. Creditors may not have an appetite for, or the debtor may not have the financial ability to, continue to operate in chapter 11 until the valuation improves, or the debtor may not have the ability to offer adequate protection to secured creditors for the use of cash collateral or to obtain DIP financing, which may limit (or allow the secured creditor to limit) the duration of the case. Accordingly, under the absolute priority rule, junior creditors and interest-holders may lose their rights against the estate and receive no value on account of their claims simply because of the timing of the valuation of the enterprise in the chapter 11 case, while secured creditors, whose rights outside of bankruptcy would have been limited to foreclosure, get the benefits of the chapter 11 case and the exclusive right to the future possibilities of the firm as a reorganized going concern.

Notably, similar valuation and distribution issues may arise in the context of a sale of all or substantially all of a debtor's assets under section 363(b) and proposed section 363x under these principles. Although the price being offered for a debtor's assets in a section 363 sale arguably reflects the current market value of those assets, to the extent the market is dysfunctional at the time of the sale, or economic or industry factors are negatively impacting valuations, the debtor's estate may be monetized at value far

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[776] N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913).

[777] *Id.* at 507–08. *See also* Ecker v. W. Pac. R.R. Corp., 318 U.S. 448 (1943); Marine Harbor Props., Inc. v. Mfrs. Trust Co., 317 U.S. 78 (1942); Consol. Rock Prods. Co. v. Du Bois, 312 U.S. 510, 520 (1941); Case v. L.A. Lumber Prods. Co., 308 U.S. 106, 122 (1939) (noting that *Boyd* adopts an absolute priority rule).

[778] Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, *supra* note 759, at 143 (citations omitted).

below what the estate could be worth at a later date to the prejudice of stakeholders lower in the pecking order of priorities. The arguable unfairness of this result is potentially intensified when the secured creditor is the purchaser of the assets, for example using a credit bid, and is able to capture the future increments in value solely for its own benefit.

b. Creditors' Rights to Reorganization Value and Redemption Option Value: Recommendations and Findings

Throughout their deliberations, the Commissioners held lengthy and thoughtful discussions concerning the rights of senior creditors in bankruptcy and how best to balance these rights with the reorganization needs of the debtor and the interests of other stakeholders.[779] The Commissioners analyzed changes and trends in the secured lending industry and financial markets generally.[780] They considered credit pricing and its relation to collateral valuations and risk assessments.[781] And they reviewed the literature representing all sides of these issues, including the commentary and studies on the perceived increase in senior creditor control in chapter 11 cases.[782]

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[779] *See Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing the importance of secured creditors' rights and the need for certainty for the capital markets when debtors are in bankruptcy), *available at* Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (same), *available at* Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 15, 2012) (stating that secured creditors need certainty that their prepetition contractual agreements will be upheld in bankruptcy and that significant changes to this certainty will cause the cost of credit to increase), *available at* Commission website, *supra* note 55.

[780] *See, e.g., Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (Oct. 17, 2012) ("The primary leveraged loan market has grown dramatically in the last 10 to 15 years."), *available at* Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Oct. 17, 2012) ("Secured lending is a critical part of the capital markets, particularly for non-investment-grade borrowers. Indeed, virtually 100% of leveraged loans are secured, and secured debt makes up 50% of the leveraged finance market as a whole."), *available at* Commission website, *supra* note 55.

[781] *See, e.g., Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 7 (Oct. 17, 2012) ("Senior secured loans sit atop the capital structure of corporations — situated above high yield bonds, convertible securities, preferred stock, and common stock — and offer corporate America a private and cheaper source of funding than would otherwise be available. Because of the senior secured nature of leveraged loans, and the protections afforded to secured lenders, investors are willing to accept a far lower yield on their investment. For example, over the last three years, leveraged B-rated loans have been priced in the primary market — that is, they yield — approximately 200 basis points less than B-rated unsecured bonds, with this substantial savings (25%) passing directly to the borrower."), *available at* Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("By providing collateral for a loan, borrowers have the option of providing their lenders with a lower-risk basis on which to extend credit, in exchange for which the borrower obtains capital at a lower price. Indeed, non-investment-grade borrowers essentially have no access to the unsecured loan market, and absent secured loans, would be forced to issue high-yield bonds or risk being shut out of access to the capital markets altogether. Borrowing on an unsecured basis at extraordinarily punitive interest rates — or being denied credit altogether — may do far more harm to a company than borrowing at more reasonable rates on a secured basis."), *available at* Commission website, *supra* note 55.

[782] *Written Statement of Lawrence C. Gottlieb, Partner, Cooley LLP: NYIC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4 (June 4, 2013) (noting that the adequate protection rules are increasingly resulting in retailer liquidation because substantially all of a distressed retailer's assets are subject to prepetition liens and because of the adequate protection provision, debtors may not use or sell their assets without

As discussed more fully in the context of adequate protection above, the Commissioners recognized the competing interests at stake and that the extreme position on either the pro-senior creditor or the pro-residual stakeholder side was not in the best interests of chapter 11 or the bankruptcy system. They strived to reach an appropriate balancing of these interests to the greatest extent possible. That balancing provides for valuing a senior creditor's collateral at (i) foreclosure value (as defined in these principles) for purposes of adequate protection, and (ii) reorganization value (as defined in these principles) for purposes of distributions in the case. The Commissioners believed that this balance would enhance a debtor's ability to obtain much-needed liquidity early in the case while allowing the senior creditor to benefit from the reorganized debtor's continued use of collateral in the ongoing business by receiving the value of its collateral on an enterprise or going concern basis later in the case. They also found that it comported with the mandate of section 506(a) that "[s]uch value shall be determined in light of the purpose of the valuation and of the proposed disposition or use of such property."[783]

The definition of reorganization value in these principles is designed to capture the total enterprise value of the firm, including value generated through the chapter 11 case. Subject to the principles regarding redemption option value described below and the courts' powers under sections 506(c) and 552(b), as described in Section VI.C.3, *Section 506(c) and Charges Against Collatera*l and Section VI.C.4, *Section 552(b) and Equities of the Case*, the principles further provide that a senior creditor should be entitled to receive the reorganization value of its collateral under a chapter 11 plan or in a section 363x sale.

The Commission received substantial testimony on the allocation of value in chapter 11 cases. Several witnesses posited that chapter 11 cases were being run for the benefit of the senior creditors and generating little, if any, value for other creditors.[784] Commentators have also observed this trend.[785]

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the lender's consent; and lenders are not consenting), *available at* Commission website, *supra* note 55. *See generally* Kenneth M. Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11*, 1 J. Legal Analysis 511, 523 (2009); Barry E. Adler, *Bankruptcy Primitives*, 12 Am. Bankr. Inst. L. Rev. 219, 239 (2004) ("Chapter 11 is not for every firm, and the Bankruptcy Code should not permit chapter 11 to be an option for a debtor with a corporate charter that provides an alternative process in the event of default."); Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. Pa. L. Rev. 1209, 1211 (2006) (discussing increased role of creditors in chapter 11 process); David A. Skeel, *Doctrines and Markets: Creditors' Ball: The "New" New Corporate Governance in Chapter 11*, 152 U. Pa. L. Rev. 917, 918 (2003) ("Whereas the debtor and its managers seemed to dominate bankruptcy only a few years ago, Chapter 11 now has a distinctively creditor-oriented cast."). *But see* Westbrook, *The Role of Secured Credit in Chapter 11 Cases*, *supra* note 750, at *1 (forthcoming 2015) (stating that "secured creditor control is less pervasive than has been asserted").

[783] 11 U.S.C. § 506(a).

[784] *See, e.g.*, *Oral Testimony of Bryan Marsal: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 19 (Oct. 26, 2012) (NCBJ Transcript) ("I think what you've got today is that because of the move from being unsecured creditor status to secured creditor status, which is happened over the last number of years that I've been in the business, it's increased the leverage of the secured creditors and thus reduced the flexibility of a rehabilitation during this process."), *available at* Commission website, *supra* note 55; *Statement of John Haggerty, Argus Management Corp.: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013) ("Over the years the secured lenders have increased their control over the company during the pre-petition period by taking dominion of the cash via lockbox sweeps; and requiring strict budgets and forbearance agreements. These actions enable the secured creditor to significantly increase their control over borrower cash and ultimately over a Chapter 11 filing should the borrower choose to go that route."), *available at* Commission website, *supra* note 55; *Written Statement of Jim Millstein, Chairman of Millstein & Co.: ASM Field Hearing*

Similarly, witnesses expressed concerns regarding the lack of a debtor's equity in its property at the commencement of its case and the challenges presented to restructuring the debtor under these circumstances.[786] The Commission also heard testimony concerning how the timing of a chapter 11 case — and the value realization event in the case (e.g., plan confirmation or sale approval) — can impact value allocations among creditors, and also how capital structures overwhelmed by secured debt and a resulting difficulty in obtaining post-petition financing to continue operations are creating increasing pressure to monetize the assets of the debtor's estate through quick section 363 sales.[787]

Before the ABI Comm'n to Study the Reform of Chapter 11, at 2 (Apr. 19, 2012) ("[B]y virtue of the significant protections afforded secured debt under Chapter 11, sophisticated creditors take pains to structure their credit extensions in secured form when lending to companies in distress. As a result, in cases where the aggregate amount of secured debt exceeds the going concern value of the enterprise, a Chapter 11 reorganization has become little more than a court-supervised assignment for the benefit of creditors."), *available at* Commission website, *supra* note 55; *Written Statement of Clifford J. White, Director, Executive Office for the U.S. Trustees: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Apr. 19, 2012) (describing how DIP lending conditions often ultimately control the fate of the debtor), *available at* Commission website, *supra* note 55; *Oral Testimony Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13 (Oct. 17, 2012) (LSTA Transcript) (noting that secured creditors have great influence over DIP lending terms), *available at* Commission website, *supra* note 55. *See also* Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *3–4 ("One of the most notable developments in chapter 11 reorganization practice in this millennium is the dramatic expansion in the power exercised by secured creditors. Financing has experienced a sea change, and today many firms enter chapter 11 with their assets full (or almost fully) encumbered. The reality then is that the entire reorganization is dependent on the good graces of the prebankruptcy controlling secured lender. That means that important stakeholders — bondholders, trade creditors, tort victims, employees, and shareholders, to name but a few — are excluded from any recovery but for the whims of the controlling secured creditor.").

[785] *See, e.g.*, Jacoby & Janger, *Ice Cube Bonds*, *supra* note 283, at 922–23 (discussing lender control exerted over timing of sales through post-petition financing and blanket liens); Anthony J. Casey, *The Creditor's Bargain and Option-Preservation Priority in Chapter 11*, 78 U. Chi. L. Rev. 759, 760 (2011) ("A secured creditor, exercising control over the debtor firm, determines that a bankruptcy filing to facilitate such a sale is the optimal strategy for the distressed firm. The debtor then files, and the sale is accomplished").

[786] *See Written Testimony of Michael R. ("Buzz") Rochelle: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Nov. 22, 2013) ("Today the newly-filed debtor is already under water; the secured lender is under-secured; and use of cash collateral generally comes with concessions that tighten security documentation and tie the debtor to a short-term budget which allows for little but locating an asset purchaser."), *available at* Commission website, *supra* note 55; *Written Statement of Kathryn Coleman, Attorney at Hughes Hubbard & Reed, LLP: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3, 4–5, 6 (Nov. 3, 2012) (stating that secured creditors have often "liened up" all the debtor's assets prior to the bankruptcy, hurting the debtor's chance at rehabilitation), *available at* Commission website, *supra* note 55. "Lenders providing post-petition financing no longer do so in order to make good returns with assured repayment, or protect their prepetition positions by getting collateral for previously unsecured loans. Instead, they often do so in order to take control of the debtor, through covenants, deadlines, and default provisions." *Id.*

[787] *See, e.g., Written Statement of Professor Anthony J. Casey: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 7, 2013) ("On the other hand, the secured creditor may exercise its foreclosure and liquidation rights when the debtor defaults. But that liquidation cuts off the future of the assets as part of a going concern. Thus, the secured creditor's claim on going concern is extinguished along with the junior creditors' claims. The secured creditor essentially has two options: take the liquidation value or keep the firm alive subject to the junior creditors' claims."), *available at* Commission website, *supra* note 55; *Written Statement of Sandra E. Horowitz: VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Feb. 21, 2013) ("Finally, a third challenge confronting creditors' committees is the growing use of quick Section 363 asset sales, a situation that can undermine their efforts to maximize recoveries for general unsecured creditors. While I recognize that a sale can be viewed as the real value of the estate and the only viable option, I would argue that this alternative can benefit the DIP lenders and possibly other secured creditors to the complete detriment of the unsecured credits who may well benefit from a classical operational and financial restructuring from which value can ultimately be realized."), *available at* Commission website, *supra* note 55.

The Commissioners debated both the underlying premises in this testimony, as well as possible ways to address the concerns.[788] The Commissioners noted the increasing concerns among commentators and practitioners regarding administratively insolvent chapter 11 cases, structured dismissals, and issues regarding value allocation in chapter 11 cases.[789] They observed that in the recent cycle of chapter 11 cases, the fulcrum security (i.e., the priority level of the class of debt in the debtor's capital structure at which the firm's enterprise value is exhausted at the time of the enterprise valuation in the case) was higher in the debtor's capital structure than in the past. Although in 1978 the fulcrum security was almost always general unsecured claims, in more recent cycles, the fulcrum security was increasingly often at the senior creditor or subordinated senior creditor level.[790]

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[788] Notably, the Commission also received and considered at length testimony on the value of secured credit in bankruptcy and the important role markets play in providing liquidity to distressed companies. *See, e.g., Oral Testimony of Elliot Ganz: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Oct. 17, 2012) ("There are two things that are especially important to the smooth functioning of the market, legal clarity and financial liquidity. First, lenders and investors need to know what the rules are prior to entering into a transaction. They need to have the confidence that the rights they've bargained for will be respected and enforced. Second, they need to know that they have the ability to sell their positions, especially when things go south."), *available at* Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2-3 (Oct. 17, 2012) ("Secured credit is also vital when the capital markets constrict, as they did just a few years ago in the aftermath of the 2008 financial crisis. At that time, when leveraged markets were barely functioning, investors were extraordinarily (and understandably) careful about investing in non-investment-grade debt. At the same time, due to the economic downturn, many companies were facing challenges to their businesses and needed capital just as the markets were freezing up. For a very large number of those companies, the solution was to access the secured debt markets."), *available at* Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("[L]essening the protections accorded secured creditors would affect loan sizes going forward. Lenders would not be willing to lend as much if they cannot be sure that they will be able to collect as much as they are owed or the value of their collateral in the event of default."), *available at* Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Nov. 15, 2012) ("Asset-based financing extended by CFA members has played an important role in financing the growth of U.S. companies for many decades. It allows companies the opportunity to obtain the working capital they need to operate and grow, and create jobs, and also provides financing for capital expenditures and the acquisition of other companies."), *available at* Commission website, *supra* note 55. Throughout deliberations — on all issues — the Commission worked to balance competing interests and perspectives.

[789] *See, e.g.*, Nan Roberts Eitel, T. Patrick Tinker & Lisa L. Lambert, *Structured Dismissals, or Cases Dismissed Outside of Code's Structure?*, Am. Bankr. Inst. J., Mar. 2011, at 20; Bruce S. Nathan & Bruce D. Buechler, *Who Pays the Freight? Interplay Between Priority Claims and a Debtor's Secured Lender*, Am. Bankr. Inst. J., Nov. 2011, at 26; Norman L. Pernick & G. David Dean, *Structured Chapter 11 Dismissals: A Viable and Growing Alternative after Asset Sales*, Am. Bankr. Inst. J., June 2010, at 1; Charles R. Sterbach & Keriann M. Atencio, *Why Johnny Can't Get Paid on His General Unsecured Claims: a Potpourri of Lingering Abuses in Chapter 11 Cases*, 14 J. Bankr. L. & Prac. 1, Art. 3 (2005).

[790] *See, e.g., Oral Testimony of Bryan Marsal: NCBJ Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 22 (Oct. 26, 2012) (NCBJ Transcript) ("If you just looked at the Lehman example, you see that at the 11th hour, various sophisticated creditors went from unsecured status to secured status and, in fact, used the safe harbors to the tune of $17 billion. The answer is more sophisticated the creditor, in this case, would be your banker. Your banker has an opportunity to take advantage of all other classes of creditors by moving effectively from unsecured status to secured status. That's happened in Lehman, and it happens every day."), *available at* Commission website, *supra* note 55; *Written Statement of Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 15, 2012) ("In the middle market cases, it is the secured debt that is the fulcrum credit."), *available at* Commission website, *supra* note 55. *See also* Christie Smythe, *"Fulcrum" Deals Rising to Prominence, Experts Say*, Law 360 (Oct. 9, 2009, 1:26 PM) ("While in the past fulcrum securities were generally unsecured bonds, secured bonds have also become fulcrum securities in some recent bankruptcy scenarios as a result of the

The Commissioners discussed the potential reasons for this trend, including the testimony from the lending community on these issues.[791] They acknowledged the potential role of various confounding factors such as economic cycles, lending practices, delay in commencing chapter 11 cases (which can be facilitated by the economic cycle and the availability of cheap money, as well as a management's resistance to a filing), outdated or underperforming business models, ineffective management, and other market or constituent pressures. They also recognized and discussed the arguments of commentators and practitioners who believe that value allocation and creditors' recoveries should remain relatively unchanged and are appropriate given parties' state law rights.[792] The Commission ultimately concluded that

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lending practices before the credit crisis, experts said."), *available at* http://www.law360.com/articles/122360/fulcrum-deals-rising-to-prominence-experts-say.

[791] *See, e.g.*, *Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 10 (Oct. 17, 2012) ("During the financial crisis of 2008-2009, primary markets for both leveraged loans and high yield unsecured bonds seized up (illustrated on Slide 6). Importantly, the senior secured high yield bond market increased dramatically to take up some of the slack, providing crucial liquidity that was otherwise unavailable. In 2007, leveraged lending volume plunged from $535 billion to $152 billion and $76 in 2008 and 2009, respectively. Similarly, unsecured high yield bond volume fell from $143 billion in 2007 to $68 billion in 2008, before recovering to $163 billion in 2009. Despite the precipitous decline in leveraged loans and unsecured high yield bonds, secured high yield bond volume moved to fill the void in 2009, with issuance of $60 billion, a ten-fold increase from 2008, and a four-fold increase from 2007, when respective volume was $6 billion and $15 billion."), *available at* Commission website, *supra* note 55; *Oral Testimony of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 28 (Oct. 17, 2012) (transcript) ("What I would say is, we've definitely seen an increase in percentages of debt raised in the high-yield bond that's secured, so you're probably talking about 25% of the high yield bond market having any kind of security around it back in '06. Today you're in the low 30s, and we peaked about 34–35% number, so it definitely picked up by about 10% during that period of time, and it was noticeable because the debt overall in the bond market was down then, so it felt like there were so many bond issuers in there, and there were because that was how you raised capital. . . . I would say that the other side of that equation was there was no loans being issued for the most part, so the secured bonds in no way filled the hole that was left behind by the loans that were not being raised. The loan market has been recovering pretty steadily, more or less, for the last three years now, but I don't know that we are back to where we were in that Golden Day of the CLO."), *available at* Commission website, *supra* note 55.

[792] *See, e.g.*, *Written Statement of Ted Basta on behalf of LSTA: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 (Oct. 17, 2012) ("Since bank loans are typically the most senior debt in a company's capital structure, and generally have first lien claim to a company's assets in the event of bankruptcy, they fare far better upon default than other indebtedness. Moreover, that level of recovery has stayed remarkably consistent over the last four credit cycles. According to an analysis by Moody's Investor Services, which tracked more than 1,000 corporate defaults since January 1987, average recoveries for bank loans were approximately 80 cents on the dollar, compared with recovery of less than 50 cents on the dollar for senior unsecured bonds and 30 cents on the dollar for subordinated bonds."), *available at* Commission website, *supra* note 55; *Written Statement of A.J. Murphy: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Oct. 17, 2012) ("[F]ocusing only on the debtors that fail to reorganize in chapter 11 ignores the far greater number of companies who avoid bankruptcy entirely, and instead develop their businesses and create jobs, because they are able to access low-cost, secured credit. The ability to pledge collateral is particularly vital to both healthy non-investment-grade and financially distressed companies. In both cases, the security interest is a critical tool in reducing the cost of credit, and in many cases is a necessary condition to the extension of credit at all. Without the ability to offer an enforceable security interest, non-investment-grade borrowers may lack sufficient access to the capital markets."), *available at* Commission website, *supra* note 55; *Written Statement of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("[B]ankruptcy reforms will not affect bankruptcy alone. Weakening the protections available to secured creditors, or reducing the recovery of holders of debt bought on the secondary market, will have a profound, and negative, effect on the availability and price of credit — particularly credit extended to non-investment-grade companies."), *available at* Commission website, *supra* note 55; *Oral Testimony of Lee Shaiman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27 (Oct. 17, 2012) (transcript) ("If you look at capital structures 10 years back and the ratios of senior secured debt to subordinated debt I would suspect that, in general, that those capital structures are not

trying to isolate the cause was futile and that a better approach would be to explore ways to enhance the value allocation rules and distribution mechanisms in chapter 11 so as to continue to protect the rights of senior creditors, protect junior creditors against being cut off entirely from the future possibilities of the firm based on a valuation at a single moment in time and based on other factors that may be outside of the debtor's control, and incentivize the major parties to reach a consensual reorganization if the underlying economics justified the debtor's emergence as an ongoing enterprise.

The Commissioners worked extensively to identify ways to achieve these goals. The Commission generally agreed that the timing of a judicially supervised reorganization in the life cycle of the credit markets generally and in the business life cycle of a given company should not dictate hard and fast distributional rules that advantage the creditors who happen to be in the senior position at a given moment in time. The Commissioners discussed this basic premise at length and the concept that a valuation date set by the effective date of a plan or the date of a section 363x sale order should not cut off all future possibilities associated with the affected assets for a junior class that appears to be significantly impaired or out of the money on the plan or sale valuation date. Accordingly, the Commission determined to recommend the following overarching principle: the general priority scheme of chapter 11 should incorporate a mechanism to determine whether distributions to stakeholders should be adjusted due to the possibility of material changes in the value of the firm within a reasonable period of time after the plan effective date or section 363x sale order date, as the case may be, which would enable junior creditors to "redeem" in full the allowed claim of the impaired senior creditors receiving the reorganization value of the company under such plan or sale.

Under this principle, even if an impaired class of senior creditors would otherwise be entitled to the entirety of the reorganization value of the firm based on its reorganization value on the effective date of the plan or date of the 363x sale order, the court should not confirm the plan over the non-acceptance of the immediately junior class or approve a sale under section 363x that is not objected to by members of the immediately junior class, as the case may be, unless the plan or the order approving the section 363x sale, as applicable, provides for an allocation of redemption option value to the immediately junior class to the extent of its entitlement thereto as described in the principles above.[793] Specifically, a chapter 11 plan may be confirmed (a) over the non-

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dramatically different."), *available at* Commission website, *supra* note 55; *Written Statement of Michael Haddad, President of the Commercial Finance Association: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11, at 3 (Nov. 15, 2012) ("If the Commission ultimately proposes reducing the rights of secured lenders in Chapter 11, then it is our organization's view that anything short of allowing secured lenders the ability to obtain the benefits provided under their pre-chapter 11 loan agreements in Chapter 11 will have the direct effect of increasing our members' risk analysis which will result in increasing the cost of credit and reducing the amount of credit extended to SME borrowers who seek relief under Chapter 11."), available at Commission website, supra note 55.*

[793] For a thoughtful analysis of "option" value in chapter 11 cases, see Casey, *supra* note 785 (explaining value distortions created by the creditors' bargain and strict adherence to the absolute priority rule, and proposing a creditors' call option to address such valuation distortions). *See also* Douglas G. Baird & Donald S. Bernstein, *Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain*, 115 Yale L.J. 1930, 1936 (2006) ("The presence of valuation uncertainty can, by itself, give option value to the claims of junior creditors even when they are, in expectation, out of the money.") It should be noted that Professor Casey talks about preserving secured creditors' nonbankruptcy foreclosure value. *See* Casey, *supra* note 785, at 789 ("The creditors'-bargain model

acceptance of the immediately junior class if and only if such immediately junior class receives not less than the redemption option value, if any, applicable to such class, and (b) over the non-acceptance of a senior class of creditors, even if the senior class is not paid in full within the meaning of the absolute priority rule, if the plan's deviation from the absolute priority rule treatment of the senior class is solely for the distribution to an immediately junior class of the redemption option value, if any, attributable to such class. Notwithstanding the foregoing, however, if a chapter 11 plan is rejected by the immediately junior class and such class challenges the reorganization value used to determine such class's entitlement to redemption option value under such plan, the plan should be confirmed over the non-acceptance of such immediately junior class if (i) the court finds, based on the evidence presented at the confirmation hearing, that such reorganization value was not proposed in bad faith, and (ii) the plan satisfies, with respect to such immediately junior class, the requirements of section 1129(b) other than the requirement that reorganization option value be provided to such class. Similarly, section 363 should be amended to provide that, in the context of a section 363x sale, if the members of an immediately junior class do not object to the sale, the immediately junior class should be entitled to receive from the reorganization value attributable to such sale not less than the redemption option value, if any, attributable to such immediately junior class. If, however, the immediately junior class objects to the sale, they will not be entitled to such redemption option value.

The Commission agreed that the principles governing redemption option value in chapter 11 cases should not apply to cases involving small and medium-sized enterprises. The Commission believed that further study and development of the principles would be needed to determine whether they could be applied in a cost-effective and meaningful manner in such cases. The Commission proposed separate principles governing confirmation of chapter 11 plans in small and medium-sized enterprise cases, in Section VII, *Proposed Recommendations: Small and Medium-Sized Enterprise (SME) Cases*.

In developing these principles, the Commissioners discussed, debated, and refined several key concepts necessary to determine whether distributions to stakeholders should be adjusted due to the possibility of changes of the value of the firm within a reasonable period of time after the plan effective date or section 363x sale order date, as the case may be. The Commission concluded that the redemption option value attributable to the immediately junior class should be the value of a hypothetical option to purchase the entire firm with an exercise price equal to the redemption price and a duration equal to the redemption period. Notably, value distributed to the immediately junior class under these principles need not be, and in most cases likely would not be, in

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requires a distributional rule that — while respecting nonbankruptcy contract rights — maximizes the aggregate pool of assets in bankruptcy. This means protecting the secured creditor's right to nonbankruptcy foreclosure value and the unsecured creditor's call option, while allocating bankruptcy rights in a way that creates the optimal incentives for the creditors. The proposed Option-Preservation Priority does precisely that."). The Commissioners debated the "foreclosure" vs. "reorganization" value issue at length and the Commission determined that, as part of the overall compromise reached in the principles, if a plan is confirmed or a sale is approved, secured creditors should be permitted to receive the reorganization value of their collateral, which could be greater than the nonbankruptcy foreclosure value.

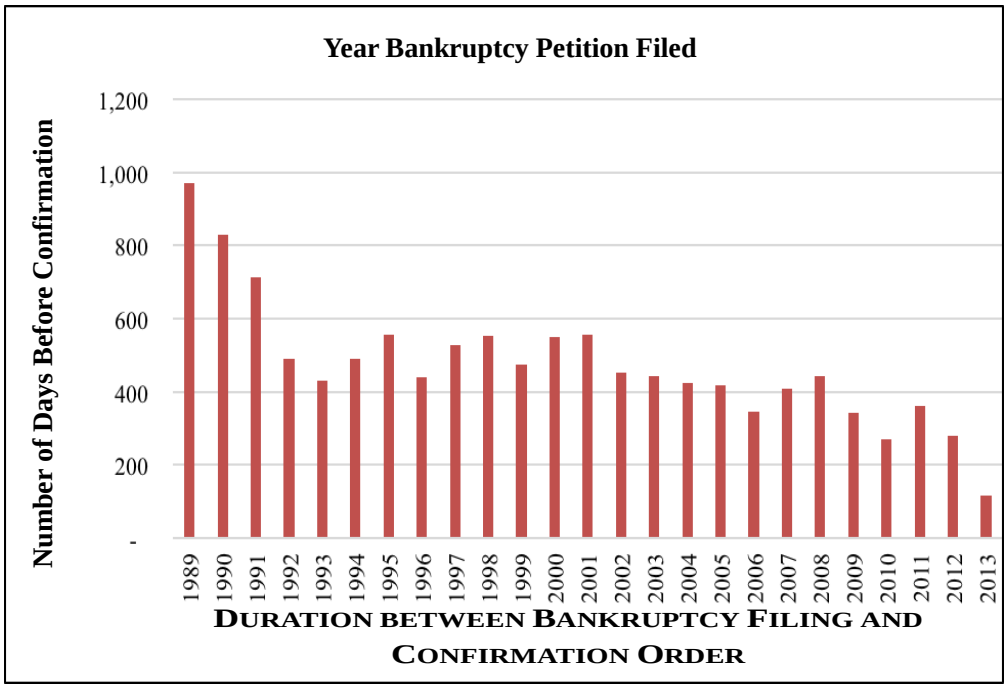
the form of an actual option. The requirement is that the requisite value be distributed to the immediately junior class, regardless of form.

Although a relatively straightforward concept in a simple capital structure (see example below), the Commissioners recognized the potential complexities of applying these principles in more involved corporate and financing structures. Accordingly, the Commissioners strived to identify principles that define the basic parameters of junior creditors' rights, with the expectation that there would be further development of the appropriate mechanisms for applying the principles in more complex cases. Indeed, the principles set forth above are not intended to alter the order of creditor priorities or to affect allocations within a particular class of creditors; rather, the principles speak generally to how courts should determine whether the value of the debtor or its assets is sufficient to support a distribution to the immediately junior class. The Commissioners acknowledged that, in implementing the redemption option value concept, the mechanism invoked by the parties and the courts will likely require further development to determine whether and how it should be applied in more complex contexts, for example where a senior class is entitled to less than all of the firm's enterprise value (for example where it is secured by only some of the assets of the firm), where contractual or structural subordination (rather than a lien) results in an immediately junior class, where there are multiple classes senior to the immediately junior class and not all senior classes are receiving distributions in the form of interests in the residual value of the firm, where only part of the immediately junior class objects to a sale or challenges reorganization value under a plan, or where some enterprise value is distributable at the current enterprise valuation to an immediately junior class, but the junior class is not being paid in full.

In their discussions of redemption option value, the Commissioners methodically examined various formulas and procedures for addressing the potential deficiencies in chapter 11 valuations based on the timing of the effective date of the plan or the date of the section 363x sale order. For example, in a simple capital structure, the Commissioners considered the following factors and steps appropriate, and they are set forth here solely for purposes of illustration:

- *First*, the Commissioners analyzed the problem at hand — e.g., timing can cause the value realization event to allocate value among creditors at a historically low valuation. The Commissioners examined the economic and financial literature and determined that most economic cycles, industry events, operational issues, etc. resolve themselves in approximately three to five years. Recognizing the need for parties to have certainty as soon as possible in the distribution context and despite strong arguments from some Commissioners for five years, the Commission decided to recommend using, as the expiration date of the exercise period for the hypothetical redemption option, a date that is three years from the petition date. Based on several factors, including the factors discussed above and the average duration of chapter 11 cases as shown in the chart below, the Commission found that determining redemption option value based on a hypothetical option expiring at the end of such a three year period (the redemption period) should be sufficient to redress the potential

unfairness of permanently crystalizing the value of the firm as of a single plan confirmation date or sale date.[794]



• *Second*, the Commissioners evaluated different ways to calculate the redemption option value — i.e., the potential value allocation to the immediately junior class at the time of the value realization event. After much debate, including discussion of concerns of some of the Commissioners that an option valuation methodology was not a good fit for the redemption concept, the Commission concluded that using a market-based method such as the Black-Scholes model purely as a working formula would likely be the best way to consistently and accurately determine the value of the hypothetical redemption option. Traditionally, a Black-Scholes model uses four factors to value an option: the strike price of an option, the term of the option, volatility, and the risk-free rate. In the context of calculating any redemption option value, (i) the strike price is 100 percent of the redemption price described above (i.e., senior class or classes must be repaid in full before any redemption option value exists), (ii) the term of the option would expire three years from the petition date (i.e., the redemption period); (iii) volatility could vary but can

[794] Mr. Shrestha prepared this chart for the Commission based on data from the New Generation's Public and Major Private Companies Database. Accordingly, it was limited to public and large private companies. The duration above is from the petition date to the date of the confirmation order. In recent years, the mean and median durations for chapter 11 reorganizations (from petition date to confirmation) are respectively: 2009 (342, 275); 2010 (269, 206); 2011 (360, 338); 2012 (281, 274); 2013 (116, 108). *See generally supra* note 65 and accompanying text (generally discussing limitation of chapter 11 empirical studies).

be determined for a particular debtor by looking at the historical volatility of comparable companies, using an agreed upon volatility rate, or using a set metric like the average 60 day forward volatility of the S&P 500 Index for the past four years (i.e., approximately 15% at the time of this Report); and (iv) the risk-free rate generally is based on the U.S. Treasury rate.[795]

- *Third*, the Commissioners tested the rule using the agreed upon calculation formula under a variety of scenarios. For example, if the senior class is entitled to the entire value of the firm and is determined to be receiving 50 percent of the principal amount of their claims (before giving effect to bifurcation of the their secured claims, if any, pursuant to section 506(a)) based on the reorganization value of the firm on a plan confirmation date as specified in the plan, and the confirmation date occurs one year after the petition date, the redemption option value likely holds no value for the immediately junior class under reasonable assumptions. Specifically, this result occurs with a 50 percent recovery to the senior class; a "strike" price (the redemption price) of 100 percent (payment in full to the senior class); a redemption period of two years (confirmation date one year after the petition date); a volatility rate of 15 percent; and a risk-free rate of 2.23 percent. If you change the percentage recovery of the senior class to 90 percent, meaning that the reorganization value of the firm is sufficient to repay the senior creditors 90 percent of the principal amount of their claims (before giving effect to bifurcation of the their secured claims, if any, pursuant to section 506(a)), the redemption option value (under the previous assumptions) is approximately 5 percent of the reorganization value, which would be distributed to the immediately junior class. Specifically, this result occurs with a 90 percent recovery to the senior class; a "strike" price (the redemption price) of 100 percent (payment in full to the senior class); a redemption period of two years (confirmation date one year after the petition date); a volatility rate of 15 percent; and a risk-free rate of 2.23 percent. The following chart depicts these results:

[795] The Black-Scholes formula or similar methodologies could identify the redemption option value once these four factors are identified and the percentage recovery of the secured creditors based on the reorganization value of the firm is determined as of the plan confirmation or section 363x sale order date. The Binomial Options Pricing Model, Monte Carlo options models, and other formulas may have to be considered where Black-Scholes is not effective to value an option on a particular enterprise.

Redemption Value Calculation based on S&P 500 Option Formula

Additional Assumptions

Risk-Free Rate: 2.23%
Term (years): 2 years remaining
Strike Price: 100% Recovery

Volatility

Recovery % on Senior Debt	12.0%	15.0%	18.0%
90.00	3.84	5.32	6.83
80.00	1.11	2.06	3.15
70.00	0.18	0.54	1.10
60.00	0.01	0.08	0.25
50.00	0.00	0.00	0.03

Redemption Option Value as a % of Reorganization Value

Notes

- The above option pricing uses Black-Scholes to determine value based on assumptions noted.
- Midpoint volatility assumption of 15% is based on 60D historical volatility for S&P 500 from July 2010 to present.
- Risk-Free Rate is based on US Treasury (2 Year) average yield from July 2000 to present.

• *Bottom-line implications of the redemption option value rule*: Where the senior class's distributions on the plan confirmation or sale order date are close to the full principal amount of their claims (before giving effect to bifurcation of the their secured claims, if any, pursuant to section 506(a)), the immediately junior class is likely to be entitled to some redemption option value. On the other hand, where the senior class is deeply impaired and its distributions on the plan confirmation or sale order date are low in comparison to the full amount of the senior class's claims, the immediately junior class is likely to be entitled to receive little or nothing. Likewise, the time remaining on the redemption period (i.e., three years from the petition date) could affect the redemption option value, with a longer period working in favor of some redemption option value (but not necessarily in all cases, as again the initial percentage recovery for the senior class greatly influences the calculation). Volatility and the risk-free rate can also impact the calculation, but likely less so than the other two factors in the redemption option value context. Moreover, as indicated in the principles, the class entitled to receive the redemption option value generally will be the class immediately junior to the

> fulcrum security class, assuming that the fulcrum security class is the principal beneficiary of the residual value of the firm under the plan.
>
> • *Note*: Redemption option value only exists if the senior class would receive the full face amount of the claims of the senior class, including any unsecured deficiency claim, plus any interest at the non-default contract rate plus allowable fees and expenses unpaid by the debtor, in each case accruing through the hypothetical date of exercise of the redemption option, as though the claims remained outstanding on the date of the exercise of the option (i.e., the redemption price). If any redemption option value exists under the foregoing calculation as of the plan effective date or section 363x sale order date, it could be paid pursuant to the plan or section 363x sale order in the form of cash, debt, stock, warrants, or other consideration, provided that any non-cash consideration would be valued on a basis consistent with the manner in which reorganization value was determined. The form of consideration used to provide redemption option value to the immediately junior class should be subject to the election of the senior class being required to give up such value, regardless of whether such senior class has accepted the plan. If no redemption option value exists on that date (or such class is not otherwise entitled to receive any redemption option value under these principles), nothing further is required and no value is distributed to such junior creditors in the case.

As explained above, the Commission recommended the addition of the redemption option value rule to the general priority scheme of the Bankruptcy Code as a minimum entitlement for the immediately junior class based on the reorganization value of the firm as of the plan effective date or section 363x sale order date. The Commissioners believed that adding the redemption option value rule would appropriately balance the competing issues at stake in the context of value realization events in a case while respecting the value of the senior creditors' interest in the debtor's property.[796]

As suggested by the principles, the redemption option value rule would apply in both the chapter 11 plan and section 363x sale process.[797] The Commissioners discussed

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[796] Tabb, *The Bankruptcy Clause, the Fifth Amendment, and the Limited Rights of Secured Creditors in Bankruptcy*, *supra* note 115, at *5 ("Outside of bankruptcy, the secured lender may have considerable difficulty capturing anything above liquidation value. If the bankruptcy process itself allows the recovery of more value, why should all of that bankruptcy-enabled excess go to the secured lender.").

[797] For a thoughtful discussion of potential value distortion in chapter 11 sales, see Jacoby & Janger, *supra* note 283, at 894–95 ("This going-concern premium is a product of the federal bankruptcy regime. Sometimes, the going-concern premium can only be obtained by acting quickly. Thus, a Bankruptcy Code created speed premium exists (as part of the going-concern premium) when a quick sale is necessary to preserve value. While both premia are worth preserving, we are concerned that parties not be able to exploit the perceived need for speed to distort the Code's distributional scheme."). In addition, Professor Casey explains such potential value distortion as follows:

> Indeed, a recent study by Kenneth Ayotte and Edward Morrison shows that the outcomes of these sales are distorted by conflict between junior and senior creditors. This conflict stems from the mismatched incentives of the different classes of creditors. On the one hand, senior creditors have an incentive to sell the company in a quick sale even when reorganization has a higher expected return for the estate. Thus, when senior creditors are exercising control — which they do in most cases — the result is an inefficient fire sale of the debtor's assets. On the other hand, junior creditors have an incentive to block the quick sale in favor of a drawn-out reorganization even when the sale has the higher expected return for the estate. Thus, in cases where the junior creditors can obtain some control — usually by

the potential challenges to applying the redemption option value rule in a section 363x sale process, particularly where the purchaser is a third party and not the senior class. In those situations, the redemption option value can still be calculated based on the net purchase price and parties can determine what, if anything, must be allocated to the immediately junior class. Some of the Commissioners were concerned, however, about paying the redemption option value when the senior class was not getting the future value of the firm *per se*. Other Commissioners noted that the senior class in these situations typically receives distributions and the benefits of the section 363x sale on a quicker timeline; from that perspective, the decision to sell forecloses the plan of reorganization alternative and the future value distributions that would flow from the reorganization. The Commission agreed that the estate — and not the third party purchaser — should be responsible for paying any redemption option value to the immediately junior class. (Of course, any such value paid from the estate will reduce the value available for the senior class.) They also recognized that excluding section 363x sales to third parties from the redemption option value rule could encourage gamesmanship and alternative deal structures that avoid the rule but effectively transfer the assets or their future value to the senior class. Likewise, excluding all section 363x sales could discourage reorganizations without addressing the important issues surrounding the timing of value realization events and value allocation in chapter 11 cases discussed above.[798]

On balance, the Commission voted to apply the redemption option value rule to plans and all section 363x sales (except in small and medium-sized enterprise cases), recognizing that in both the plan and the sale contexts, this default rule will likely encourage consensual resolutions that benefit all. The Commission also acknowledged that the redemption option value principles set forth in this Report are essentially guidelines for courts and parties to use in developing such value allocation principles for more nuanced and complex capital structures than those vetted by the Commission. The Commission found great potential utility to the redemption value option, and it encourages the restructuring community and commentators to build upon this concept to more completely develop fair allocation rules in chapter 11 cases.

2. New Value Corollary

Recommended Principles:

- A pre-petition interest-holder, including an insider, should be permitted to retain or purchase an interest in the reorganized debtor without violating the absolute priority rule of section 1129(b)(2)(B)(ii) or section 1129(b)(2)(C)(ii) of the Bankruptcy Code, if applicable, provided that such interest-holder contributes new money or money's worth to the debtor's reorganization efforts in an aggregate amount that is reasonably proportionate to the interest retained or purchased and that is subject to a reasonable market test.

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prevailing on procedural objections — there may be a distortion in favor of an inefficient and prolonged reorganization.

Casey, *supra* note 785, at 761–62 (citations omitted).

[798] The Commissioners discussed similar considerations in determining that a secured creditors' section 1111(b) election should not be operative under the redemption option value rule.

a. New Value Corollary: Background

As described in the preceding section, the absolute priority rule requires that senior classes of claims or interests be paid in full prior to junior classes receiving any distributions under the chapter 11 plan. Consequently, pre-petition equity security holders generally cannot retain or receive new equity in the reorganized debtor unless all creditors are paid in full under the plan. This general rule predates the Bankruptcy Code and finds its origins in the equity receiverships of the early 1900s. As the U.S. Supreme Court explained in *Boyd*, "creditors [are] entitled to be paid before the stockholders could retain [equity] for any purpose whatever."[799]

One question that arises in the context of pre-petition equity security holders and the absolute priority rule is whether pre-petition equity security holders can purchase equity from, or contribute new value to retain equity in, the reorganized debtor. This potential exception to the absolute priority rule is commonly called the new value exception or corollary.[800] The Supreme Court provided some guidance on the new value corollary in *Bank of America National Trust and Savings Assn. v. 203 North LaSalle Street Partnership*.[801] In *203 North LaSalle*, the Supreme Court held: "A debtor's pre-Bankruptcy equity security holders may not, over the objection of a senior class of impaired creditors, contribute new capital and receive ownership interests in the reorganized entity, when that opportunity is given exclusively to the old equity security holders under a plan adopted without consideration of alternatives."[802] Although the Supreme Court acknowledged that the new value corollary might exist under some circumstances,[803] it did not resolve the issue. Lower courts have adopted different approaches to assessing this potential exception.

Courts and commentators generally have interpreted *203 North LaSalle* as requiring a "market test" before a court confirms a chapter 11 plan in which pre-petition equity security holders retain or receive equity in the reorganized entity in violation of the absolute priority rule.[804] Courts do not, however, necessarily agree regarding the parameters of this market test or the minimum process required to satisfy the *203 North LaSalle* standard. In fact, some courts appear to limit the potential market tests to the

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[799] N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913).

[800] Courts consider several factors in assessing the new value corollary and generally require that the purported new value be (i) new, (ii) substantial, (iii) in money or money's worth, (iv) necessary for a successful reorganization, and (v) reasonably equivalent to the value of the stock being retained or received. *See, e.g.*, Bonner Mall P'ship v. U.S. Bancorp Mort. Co. (In re Bonner Mall P'ship), 2 F.3d 899, 908 (9th Cir. 1993), *cert. granted sub nom.* U.S. Bancorp Mortg. Co. v. Bonner Mall P'ship, 510 U.S. 1039 (1994), *motion to vacate denied and case dismissed*, 513 U.S. 18 (1994).

[801] Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434 (1999).

[802] *Id.*

[803] *See id.* ("The upshot is that this history does nothing to disparage the possibility apparent in the statutory text, that the absolute priority rule now on the books as subsection (b)(2)(B)(ii) may carry a new value corollary."). *See also* Nicholas L. Georgakopoulos, *New Value After* LaSalle, 20 Bankr. Dev. J. 1, 2 (2003) (observing that the Supreme Court affirmed the new value corollary in *LaSalle*).

[804] *See, e.g., In re* Castleton Plaza, LP, 707 F.3d 821 (7th Cir. 2013) (rejecting new value plan because lack of market competition prevented court from being able to test purported new value in exchange for grant of 100 percent of reorganized equity to insider in violation of absolute priority rule). *See also* Robert J. Keach, LaSalle, *The "Market Test" and Competing Plans: Still in the Fog*, Am. Bankr. Inst. J., Dec. 2002, at 18 (2002).

two examples identified by the Supreme Court in *203 North LaSalle* — i.e., a competing chapter 11 plan or competitive bidding.[805]

b. New Value Corollary: Recommendations and Findings

The Commissioners discussed the new value corollary and its potential role in facilitating plans of reorganization. Several Commissioners commented on the need to provide some mechanism to allow pre-petition equity security holders to retain or receive equity in the reorganized debtor. They noted that this issue was particularly relevant in cases where pre-petition equity security holders included founders or other individuals whose continued association with the business was critical or valuable to the reorganized debtor. In this regard, these Commissioners believed that authorizing the new value corollary furthered the underlying reorganization goals of chapter 11.

The Commissioners also discussed instances in which pre-petition equity security holders were the only, or most viable source, of funding for the chapter 11 plan. Some of the Commissioners observed that, in such cases, the requirements of the new value corollary, including the market test component, should be easily satisfied. Other Commissioners noted, however, that the uncertainty surrounding the application of the new value corollary can make this an expensive and, in some cases, impracticable process. The Commission reviewed the testimony it received on the new value corollary and the impediment it can pose to plan confirmation.[806]

The Commission determined that chapter 11 reorganizations would benefit from further clarity on the new value corollary. It agreed that codifying the new value corollary as an expressed exception to the absolute priority rule and identifying the key elements of the exception would enhance the confirmation process in many cases. Accordingly, the Commission recommended a statutory new value corollary that required (i) new money or money's worth; (ii) in an amount proportionate to the equity received or retained by pre-petition equity security holders; and (iii) that would be subject to a "reasonable" market test. The Commission declined to define an appropriate market test; rather, it believed that courts should make this determination based on the facts, the evidence presented, and what would be reasonable in the particular case before the court.

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[805] *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 458 (1999) ("Whether a market test would require an opportunity to offer competing plans or would be satisfied by a right to bid for the same interest sought by old equity is a question we do not decide here."). *See also In re* Situation Mgmt. Sys., 252 B.R. 859, 861, 865 (Bankr. D. Mass. 2000) (rejecting new value plan "was not confirmable in the absence of competitive bidding for the equity interests to determine the adequacy of the new value contribution").

[806] *See, e.g.*, *Written Statement of Maria Chavez-Ruark: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 7, 2012) (discussing inconsistencies in the application of the new value corollary). "The corollary makes sense from a policy standpoint. The underlying policy for a reorganization is rehabilitation of the business, as failed businesses lead to a loss of jobs and loss of capital, both manifestations of economic inefficiency. The new value corollary recognizes that equity holders who inject new capital into a restructured business are not gaining a position ahead of creditors because of their old equity position. Instead, they are taking a concrete step to restore the business to solvency by paying fair value for the reorganized debtor's stock." *Id.*

3. Section 506(c) and Charges Against Collateral

Recommended Principles:

- The trustee should not be permitted to waive its ability to surcharge collateral, or to agree not to pursue such a surcharge, to the extent permitted under section 506(c) of the Bankruptcy Code. The surcharge under section 506(c) should continue to apply only to collateral securing pre-petition debt and should not apply to new money extended solely on a post-petition basis.

a. Section 506(c) and Charges Against Collateral: Background

Two common questions arise in the context of proceeds from property serving as collateral for a secured creditor: Can those proceeds be used to reimburse the estate for the cost of maintaining and monetizing the property, and can those proceeds be used to pay general administrative or other claims against the estate? The Bankruptcy Code addresses the first question, but it does not speak directly to the second.

Section 506(c) of the Bankruptcy Code provides: "The trustee may recover from property securing an allowed secured claim the reasonable, necessary costs and expenses of preserving, or disposing of, such property to the extent of any benefit to the holder of such claim, including the payment of all ad valorem property taxes with respect to the property."[807] This section protects the estate, and it allows the trustee[808] to request payment for money expended on, or resources committed to, a secured creditor's collateral.[809] In addition, the trustee must establish that the expenditures were "reasonable" and "necessary" and provided a benefit to the secured creditor. The section protects a secured creditor's collateral by incentivizing the trustee to preserve that collateral. It also protects the estate by ensuring that the secured creditor pays for this protection.[810]

Courts have encountered several issues in applying section 506(c), including the scope of expenses included within the section and the identity of parties with standing to request payment under the section. Determining the kind of expenses that may be paid from a secured creditor's collateral is a fact-intensive inquiry.[811] Costs directly related to the maintenance and preservation of the collateral typically are covered.[812] In

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[807] 11 U.S.C. § 506(c).

[808] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[809] "Any time the trustee expends money to provide for the reasonable and necessary cost and expenses of preserving or disposing of a secured creditor's collateral, the trustee is entitled to recover such expenses from the secured party or from the property securing an allowed secured claim held by such party." 124 Cong. Rec. H11089 (Sept. 28, 1978), *reprinted in* 1978 U.S.C.C.A.N. 6436, 6451.

[810] *See, e.g.*, Loudoun Leasing Dev. Co. v. Ford Motor Credit Co. (*In re* K&L Lakeland, Inc.), 128 F.3d 203 (4th Cir. 1997); *In re* TIC Memphis RI 13, LLC, 498 B.R. 831 (Bankr. W.D. Tenn. 2013). *See also* Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1 (2000) (explaining that section 506(c) stems from practices under the Bankruptcy Act and "trac[ing] its origin to early cases establishing an equitable principle that where a court has custody of property, costs of administering and preserving the property are a dominant charge") (citations omitted).

[811] *See* 4 Collier on Bankruptcy ¶ 506.05[9] (16th ed. 2014).

[812] *See id.*

addition, the trustee may be able to recover certain costs associated with operating the business if those expenditures in turn benefited the secured creditor.[813] Whether the trustee can recover its attorneys' fees and expenses, however, is less clear. Courts scrutinize such requests closely and permit recovery in only very limited circumstances. The Third Circuit has explained that a debtor in possession's attorneys' fees and expenses "may be charged only against the surplus of the debtor's estate."[814]

The trustee's attorneys' fees and expenses are only one type of administrative claim that may be incurred pending the sale of a secured creditor's collateral. As suggested above, whether any particular administrative claim is within the scope of section 506(c) turns on whether the expenditure was reasonable and necessary to preserve or monetize the collateral, and whether it provided some benefit to the secured creditor as a result. The statute clearly allows the trustee to assert a claim under section 506(c) for such expenses, and most courts have held that administrative claimants themselves lack standing to assert such claims.[815] In *Hartford Underwriters* (*In re Hen House*), the U.S. Supreme Court specifically held that section 506(c) "does not provide an administrative claimant an independent right to use the section to seek payment of its claim."[816] The Court declined to address, however, whether administrative claimants could assert such claims derivatively through the trustee.[817] Lower courts are split on this standing issue.[818]

The payment of general administrative claims and other types of claims not related to the preservation or monetization of the secured creditor's collateral is not addressed by section 506(c).[819] As discussed above, the language of section 506(c) links the use of collateral proceeds to costs associated in some way with that collateral, and courts generally construe the statute narrowly. The statute thus does not cover "carve-outs" from a secured creditor's collateral to pay other administrative claims or unsecured claims. "As generally used, a carve out is an agreement between a secured lender, on the one hand, and the trustee . . . on the other, providing that a portion of the secured creditor's collateral may be used to pay administrative expenses."[820]

A secured creditor can agree with the trustee to allow certain costs and claims to be paid from the proceeds of the secured creditor's collateral. Such carve-outs are common

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[813] *See In re* Flagstaff Foodservice Corp., 739 F.2d 73 (2d Cir. 1984). What costs are "reasonable" and "necessary" in the operationof the business again is a fact-specific inquiry. For example, in sale-based cases, under section 506(c), a court may entertain requests for: (i) the costs of plan completion after the sale of the asset (*i.e.*, "burial expenses"); (ii) professional expenses until the sale date; (iii) the tax consequences of any realized gain from the sale; (iv) payment of section 503(b)(9) claims; (v) break-up fees or expenses; and (vi) costs of preserving the going concern of a portion of a business that is sold.

[814] *In re* Towne, Inc., 536 Fed. App'x 265 (3d Cir. 2013).

[815] 11 U.S.C. § 506(c).

[816] Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1 (2000).

[817] *Id.*

[818] Standing to bring a section 506(c) claim was addressed in *In re Ramo Practice Mgmt., Inc.*, 2005 WL 6483309, at *1 (Bankr. S.D. Cal. June 17, 2005), where the court declined to grant the debtor's attorney a section 506(c) claim for services rendered that fell within the "normal scope of services" and the trustee explicitly agreed with the court. In contrast, in *In re Sak Dev., Inc.*, 2008 WL 619378, at *1 (Bankr. E.D.N.C. Feb. 29, 2008), without any analysis of standing, the court granted a section 506(c) reimbursement claim to a creditor for work performed on a project.

[819] *See, e.g.*, United Jersey Bank v. Miller (*In re* C.S. Assocs.), 29 F.3d 903, 907 (3d Cir. 1994) (explaining that section 506(c) "was designed to extract from a particular asset the cost of preserving or disposing of that asset").

[820] Richard B. Levin, *Almost All You Ever Wanted to Know About Carve Out*, 76 Am. Bankr. L. J. 445 (2002).

in debtor in possession financing facilities and are subject to approval by the court. The trustee may request authority to pay administrative claims and other claims from a secured creditor's collateral, but absent satisfying the elements of section 506(c) or obtaining the secured creditor's consent, courts generally deny requests for these types of surcharges.[821] In practice, debtor in possession financing facilities suggest that secured creditors may consent to limited carve-outs in exchange for an *ex ante* waiver of the debtor in possession's right to surcharge the collateral under section 506(c).[822]

b. Section 506(c) and Charges Against Collateral: Recommendations and Findings

The scope of section 506(c) and a trustee's ability to surcharge property has gained importance as debtors file chapter 11 cases with fewer unencumbered assets or little free cash flow to facilitate the reorganization. Any funds expended by the trustee on account of a secured creditor's collateral arguably deplete the funds available to rehabilitate the debtor or pay general administrative claims. Yet, from the secured creditor's perspective, the debtor's retention of the collateral is helping to facilitate the reorganization and delaying the secured creditor's ultimate recovery on the collateral.

The Commission considered these competing perspectives and the tension created when estate resources are devoted to the preservation or disposition of a secured creditor's collateral, and administrative claims and unsecured creditors are not being paid.[823] The Commissioners discussed the types of claims typically surcharged against collateral under section 506(c), and the courts' approach to identifying whether a charge benefited the secured creditor. They also acknowledged that section 506(c) claims are litigated infrequently because those rights are commonly waived in connection with post-petition financing facilities or cash collateral agreements. This waiver often forces the trustee to rely on any consensual carve-outs negotiated in the case, or upon the secured creditor's *ex post* agreement to fund certain claims necessary to facilitate a sale of the collateral.

In light of these experiences, the Commission considered whether section 506(c) should be expanded to allow a court to charge a secured creditor's collateral for costs associated with the administration of the case that may not evidence a direct benefit to the secured creditor or the collateral. For example, the Commissioners engaged in an in-depth debate concerning costs incurred to wind down an estate subsequent to a sale of a secured creditor's collateral. Some of the Commissioners believed that such "burial costs" could provide a direct benefit to the secured creditor because, without some assurance that the case can be completed in an orderly fashion, the court should not allow the debtor and the secured creditor to sell the collateral under section 363 of the Bankruptcy Code. Other Commissioners disputed this characterization and noted that

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[821] *See, e.g., In re* Cal. Webbing Indus., Inc., 370 B.R. 480 (Bankr. D.R.I. 2007).

[822] *But see In re* Tenney Village Co., Inc., 104 B.R. 562, 567 (Bankr. D.N.H. 1989) ("Under the guise of financing a reorganization, the Bank would disarm the Debtor of all weapons usable against it for the bankruptcy estate's benefit, place the Debtor in bondage working for the Bank, seize control of the reins of reorganization and steal a march on other creditors in numerous ways.").

[823] Barry E. Adler, *Priority in Going-Concern Surplus*, 2015 Ill. L. Rev. (forthcoming 2015) (discussing the potential difficulties of the proposed surcharge of the debtor's estate to reallocate a debtor's going-concern surplus instead of allowing it all to go to the secured creditor) (draft on file with Commission).

the secured creditor could have sold the collateral outside of bankruptcy and that often it is the debtor, and not the secured creditor, electing to invoke chapter 11. In this context, the Commissioners discussed the benefits of the chapter 11 process as providing a national foreclosure forum, the avoided costs to using the bankruptcy process, and whether the Bankruptcy Code should, as a matter of policy, permit chapter 11 to be used for this purpose. The Commissioners agreed that asset and business sales had become an integral part of the chapter 11 process and considered ways to balance competing claims to the debtor's limited resources in this environment.[824]

The Commission determined that the current scope of section 506(c) was appropriate, and that the required nexus between the estate's expenditures and the secured creditor's collateral was an appropriate gating feature of this provision.[825] The Commissioners were comfortable with courts' interpretations and applications of the "reasonable" and "necessary" standards, as well as the circumstances in which secured creditors benefit from the expenditures. The Commissioners noted that in certain instances, burial costs and other costs associated with the operation of the business or the winding down of the case, may satisfy the section 506(c) elements, but that those determinations should be made by the courts on a case-by-case basis.

The Commissioners observed that the utility of section 506(c) in this context turns in part on the trustee being able to assert, and the court being able to assess, claims for reimbursement of expenses under that section. If the trustee has waived its right to assert claims under section 506(c), the court does not have the opportunity to consider the appropriate allocation of expenses between the estate and the secured creditor.

The Commission considered whether this type of waiver should be permissible.[826] Although the Commissioners recognized that even if section 506(c) claims are waived, the trustee may have negotiated a carve-out, and they did not believe that consensual carve-outs always represent a good alternative for the estate. The trustee typically has little bargaining leverage in negotiating the carve out, and these provisions are limited in amount and can be limited in scope to only those items approved by the secured creditor. The Commissioners also expressed concerns regarding a waiver that impacts not just the trustee, but also other stakeholders who are beneficiaries of the estate.

On balance, the Commission determined that although section 506(c) should continue in its current form, the Bankruptcy Code should be amended to prohibit any waivers of, or stipulations regarding, a trustee's rights under section 506(c). The trustee's ability to invoke, and the court's authority to review, claims brought under section 506(c) should be preserved for the benefit of the entire estate. The

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[824] For a discussion of the payment of these costs in the sale context, see Section V.B.1, *General Provisions for Non-Ordinary Course Transactions* and Section VI.B, *Approval of Section 363x Sales*.

[825] *See, e.g.*, *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 4-5 (Nov. 15, 2012) (explaining that while "prepetition lending expectations should be preserved . . . the secured creditor should also be required to bear the reasonable costs and expenses incurred in connection with the preservation and disposition of the collateral (a concept presently addressed by §506(c) of the Code)"), *available at* Commission website, *supra* note 55.

[826] If approved in connection with post-petition financing, courts generally enforce the waivers. *See, e.g.*, Weinstein, Eisen & Weiss v. Gill (*In re* Cooper Commons LLC), 512 F.3d 533, 535–36 (9th Cir. 2008) (denying section 506(c) claim by debtor's former counsel, who represented the debtor in negotiating post-petition financing agreement including the waiver, based on *res judicata*).

Commissioners also believed that consensual carve-outs should still be permissible, but not to the exclusion of section 506(c) claims.

4. Section 552(b) and Equities of the Case

Recommended Principles:

- The trustee should not be able to waive, or to enter into any agreement affecting, a court's ability to limit or alter a secured creditor's interest in the debtor's or the estate's property based on the equities of the case under section 552(b) of the Bankruptcy Code.
- A trustee should not be required to establish an actual expenditure of funds to show that the estate enhanced the value of a secured creditor's collateral for purposes of the equities of the case determination under section 552(b). Rather, the trustee should be able to make such a showing with evidence of any value provided, obligation incurred, or other actions taken with respect to the collateral. With this clarification, the court should continue to determine the scope and meaning of the term "equities of the case" based on the facts of, and evidence presented in, the particular case.
- The Commission considered and declined to adopt a federal definition of the term "proceeds" for purposes of chapter 11 cases.

a. Section 552(b) and Equities of the Case: Background

Section 552 of the Bankruptcy Code addresses the post-petition effect of pre-petition liens on the debtor's property.[827] Section 552(a) establishes the general rule that the bankruptcy filing cuts off a creditor's rights under any after-acquired property clause in a pre-petition security agreement with the debtor.[828] Section 552(b) sets forth two exceptions to this general rule, one dealing with proceeds of pre-petition collateral,[829] and the other dealing with rents and similar payments relating to pre-petition collateral.[830] The exceptions basically allow the secured creditor's pre-petition lien to continue in post-petition proceeds of, or post-petition rents relating to, pre-petition

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[827] 11 U.S.C. § 552.

[828] Section 552(a) provides: "Except as provided in subsection (b) of this section, property acquired by the estate or by the debtor after the commencement of the case is not subject to any lien resulting from any security agreement entered into by the debtor before the commencement of the case." 11 U.S.C. § 552(a).

[829] Section 552(b)(1) provides:

> Except as provided in sections 363, 506(c), 522, 544, 545, 547, and 548 of this title, if the debtor and an entity entered into a security agreement before the commencement of the case and if the security interest created by such security agreement extends to property of the debtor acquired before the commencement of the case and to proceeds, products, offspring, or profits of such property, then such security interest extends to such proceeds, products, offspring, or profits acquired by the estate after the commencement of the case to the extent provided by such security agreement and by applicable nonbankruptcy law, except to any extent that the court, after notice and a hearing and based on the equities of the case, orders otherwise.

11 U.S.C. § 552(b)(1).

[830] 11 U.S.C. § 552(b)(2). The language of section 552(b)(2) is similar to that of section 552(b)(1) except that it applies "to amounts paid as rents of such property or the fees, charges, accounts, or other payments for the use or occupancy of rooms and other public facilities in hotels, motels, or other lodging properties." *Id.*

collateral. Each exception in turn is subject to an exception: the court, after notice and a hearing, may treat the secured creditor's pre-petition lien differently "based on the equities of the case." The language of section 552(b) represents a compromise between the House and Senate versions of the 1978 bankruptcy bill: The final version allowed pre-petition liens to continue in post-petition proceeds, but cabined such liens when necessary to protect the estate based on the equities of the case.[831]

The equities of the case exception allows a court to limit, alter, or terminate the extension of a secured creditor's pre-petition lien to post-petition property of the estate. Although the Bankruptcy Code does not define "equities of the case," the legislative history suggests that the exception was intended to compensate the estate for use of unencumbered property or expenditures that enhanced the value of the secured creditor's lien and to protect the rehabilitative purposes of the Bankruptcy Code. For example, the legislative history provides: "[T]he 'equities of the case' provision . . . is designed, among other things, to prevent windfalls for secured creditors and to give the courts broad discretion to balance the protection of secured creditors, on the one hand, against the strong public policies favoring continuation of jobs, preservation of going concern values and rehabilitation of distressed debtors, generally."[832] The Fourth Circuit has explained: "It appears clear from the legislative history related to § 552 that Congress undertook in that section to find an appropriate balance between the rights of secured creditors and the rehabilitative purposes of the Bankruptcy Code."[833]

In applying the equities of the case exception, courts generally consider three factors: (i) the amount of time and estate funds expended on the collateral; (ii) the relative position of the secured party following the expenditure of estate time and money (i.e., whether the collateral has been enhanced); and (iii) the rehabilitative nature of the bankruptcy case.[834] Neither the language of the statute nor the legislative history requires the estate to have devoted money or unencumbered assets to the improvement of the secured creditor's position, but some courts have applied the equities of the case exception in this manner. For example, in *Laurel Hill*, the court held that when a post-petition financing facility was repaid from proceeds that were subject to the security interests of various secured claimants whose liens had been transferred to the sale proceeds, the payments were not at the expense of the estate and thus did not support an equities of the case award to the unsecured creditors.[835] Nevertheless, in *Residential Capital*, the court invoked the equities of the case exception under section 552(b)(1) to cut off the secured creditor's lien in post-petition goodwill when "time, effort, and expense by the Debtors' estates" enhanced the value of the assets sold in the case.[836]

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[831] Section 552(b) represents a compromise between the House bill and the Senate amendment. Proceeds clauses, but not after acquired property clauses, are enforceable under the Bankruptcy Code. The provision allows the court to consider the equities of the case. In the course of such consideration, the court may evaluate any expenditures by the estate relating to proceeds and any related improvement in the secured party's position.

[832] 140 Cong. Rec. H. 10,768 (Oct. 4, 1994).

[833] United Va. Bank v. Slab Fork Coal Co. (*In re* Slab Fork Coal Co.), 784 F.2d 1188, 1191 (4th Cir. 1986), *cert. denied*, 477 U.S. 905 (1986).

[834] *See In re* Laurel Hill Paper Co., 393 B.R. 89, 93 (Bankr. M.D.N.C. 2008).

[835] *Id.*

[836] *See* Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (*In re* Residential Capital, LLC), 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013).

Similar to section 506(c), the trustee[837] often waives its right to assert the equities of the case exception under section 552(b), or stipulates that no such equities exist, in connection with post-petition financing or the use of cash collateral.[838] Perhaps because of these waivers, relatively little case law exists on section 552(b).

b. Section 552(b) and Equities of the Case: Recommendations and Findings

Section 552 represents a basic compromise: Pre-petition secured creditors can maintain their interests in the debtor's pre-petition property, including proceeds, but the trustee can use property acquired by the estate unencumbered by any pre-petition liens. This balance provides the trustee with resources to help facilitate the debtor's reorganization. Nevertheless, to the extent the trustee expends any of these or other estate resources in a manner that enhances the value of a secured creditor's collateral, section 552(b) permits the court to assess the equities of allowing the secured creditor to retain that enhancement.

The Commissioners observed the relationship between sections 506(c) and 552(b) of the Bankruptcy Code in that both seek to give the secured creditor the value of its allowed secured claim while preventing the secured creditor from receiving any windfalls in the case. These sections are also tied in certain respects to the valuation of a secured creditor's collateral for purposes of adequate protection requests and ultimate distributions in the case. Accordingly, the Commission considered the appropriate scope and use of section 552(b) in the context of the recommended principles relating to section 506(c), foreclosure value, and reorganization value.[839]

The Commissioners identified several issues in the application of section 552(b), including defining the scope of the secured creditor's pre-petition collateral package and the broad interpretation of "proceeds" and related terms under applicable state law. With respect to collateral identification, the Commission reviewed the *Residential Capital* decision and its discussion of post-petition goodwill by the Honorable Martin Glenn of the U.S. Bankruptcy Court of the Southern District of New York.[840] In that case, Judge Glenn rejected the pre-petition secured creditor's claim to post-petition goodwill on several grounds. Specifically, he determined that the pre-petition secured creditors failed to show that their collateral was converted into post-petition goodwill and that, even if the secured creditor's collateral "was used to generate goodwill (either

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[837] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[838] For example, the court made the following finding in its final order approving post-petition financing in the *General Growth Properties* chapter 11 case:

> In light of the Lenders' agreement to subordinate their liens and superpriority claims to the Carve-Out, the Lenders are entitled to a waiver of (i) the provisions of section 506(c) of the Bankruptcy Code and (ii) any "equities of the case" claims under section 552(b) of the Bankruptcy Code, in each case, in respect of the DIP Documents.

In re Gen. Growth Props., Inc., 09-11977 (ALG) (May 14, 2009).

[839] *See* Section VI.C.3, *Section 506(c) and Charges Against Collateral*; Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.

[840] Official Comm. of Unsecured Creditors v. UMB Bank, N.A. (*In re* Residential Capital, LLC), 501 B.R. 549, 612 (Bankr. S.D.N.Y. 2013).

by maintaining or improving the value of assets or by diminishing liabilities), Debtor resources were used as well."[841] Judge Glenn concluded that the use of the debtor's resources, at least in part, to transform the collateral into post-petition goodwill precluded the goodwill from being characterized as proceeds for purposes of section 552(b).

The Commissioners debated the facts and holding in *Residential Capital* and the potential approaches to resolving those issues. Some of the Commissioners supported excluding all post-petition goodwill from a pre-petition secured creditor's collateral package. They reasoned that the value generated post-petition by the debtor in possession's efforts and resources, as well as value associated with costs and obligations avoided through the chapter 11 process, should be available to support the debtor's reorganization. The Commissioners discussed the impact of such a bright-line rule regarding goodwill on credit markets and the challenge of allocating value between pre-petition and post-petition goodwill. The Commission agreed that the treatment of goodwill was best determined through a case-specific inquiry based on the facts of the case and the evidence presented at the hearing.

Similarly, the Commissioners examined the scope of the term "proceeds" under state law. Several of the Commissioners noted the significant expansion of the definition of proceeds under state law since the enactment of the Bankruptcy Code in 1978. They discussed how these kinds of amendments arguably allowed state commercial law to restrict the resources available to support a debtor's reorganization under chapter 11. They provided examples of parties litigating the scope of proceeds and reflected on two articles by Professor Ray Warner concerning the continued expansion of the concept under state law.[842] Professor Warner posits that certain amendments to Article 9 of the Uniform Commercial Code, including the expanded definition of proceeds, "had little or no nonbankruptcy function, but were designed primarily to alter bankruptcy law outcomes in favor of secured creditors."[843] Several of the Commissioners supported a federal definition of proceeds that would scale back the definition to the replacement or substitution of collateral concept originally assigned to proceeds of collateral. Other Commissioners suggested that a federal definition of proceeds that conflicted with state law would create uncertainty and increase costs in secured credit transactions. The Commission ultimately declined to adopt a federal definition of proceeds.

The Commissioners then considered whether section 552(b) strikes the appropriate balance between the rights of secured creditors and the estate. The Commissioners generally agreed with the continuation of a secured creditor's lien in proceeds subject to

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[841] *Id.*

[842] *See, e.g.*, G. Ray Warner, *Article 9's Bankrupt Proceeds Rule: Amending Section 552 Through the UCC's "Proceeds" Definition*, 46 Gonzaga L. Rev. 521 (2011); G. Ray Warner, *The Anti-Bankruptcy Act: Revised Article 9 and Bankruptcy*, 9 Am. Bankr. Inst. L. Rev. 3, 5–6 (2001). *See also* Moringiello, *When Does Some Federal Interest Require a Different Result?*, *supra* note 280 ("The Code recognizes the secured creditor's entitlement to the value of its collateral, and also recognizes that the creditor's security interest extends to proceeds of its collateral, even if those proceeds are realized after the debtor has filed for bankruptcy. The 2001 Amendments to Article 9 of the Uniform Commercial Code expanded the definition of proceeds to include 'rights arising out of the collateral' a definition that could so expand the idea of proceeds as to deprive unsecured claimants of any recovery at all.").

[843] Warner, *Article 9's Bankrupt Proceeds Rule*, *supra* note 842, at 521.

the equities of the estate exception, but several of the Commissioners expressed discomfort with the kinds of expenditures and evidence required for the trustee to establish the exception. These Commissioners commented that, if the section is concerned with enhancements of value and promoting rehabilitation, the trustee should be able to satisfy the equities of the case exception with evidence of the estate contributing value, whether through time, effort, money, property, other resources, or cost savings. The basic premise should be that, if the estate creates value through any means during the chapter 11 case and such value enhances the secured creditor's collateral, the estate should receive the benefit of such value. The extent of value attributed to the estate would be determined by the court based on the evidence presented under the equities of the case exception. The Commission agreed that so long as the evidence establishes the estate's expenditures (in whatever form), this clarification to the scope of the equities of the case exception would be beneficial and aligned with the objectives of the related principles.

Finally, as with section 506(c) and for similar reasons, the Commission voted to recommend that parties not be permitted to waive the equities of the case exception under section 552(b) or to stipulate that no equities exist to invoke the exception. The Commission agreed that such determinations should be made *ex post* based on the circumstances of the case and the evidence presented by the parties.

5. Cramdown Interest Rates

Recommended Principles:

- Under section 1129(b)(2)(A), the court should apply an appropriate discount rate to determine the present value of any deferred cash payments being made to the secured creditor under the chapter 11 plan on account of the creditor's allowed secured claim. The present value of such deferred cash payments should equal at least the amount of the secured creditor's allowed secured claim as of the effective date of the chapter 11 plan.
- In selecting the appropriate discount rate, the court should consider the evidence presented by the parties at the confirmation hearing and, if practicable, use the cost of capital for similar debt issued to companies comparable to the debtor as a reorganized entity, taking into account the size and creditworthiness of the debtor and the nature and condition of the collateral, among other factors. If such a market rate is not available or the court determines that an efficient market does not exist, the court should use an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor, considering factors such as the debtor's industry, projections, leverage, revised capital structure, and obligations under the plan. The court should not apply the "prime plus" formula adopted by the Supreme Court in *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004) in the chapter 11 context.

a. Cramdown Interest Rates: Background

Section 1129(b)(2)(A) sets forth three options for cramming down secured creditors. The plan must generally (i) permit the secured creditor to retain its lien and provide the secured creditor with deferred cash payments having a present value equal to the amount of the secured creditor's allowed secured claim; (ii) sell the collateral and permit the secured creditor's lien to attach to the proceeds; or (iii) provide the secured creditor with the indubitable equivalent of its claim. Although the first option of lien retention and cash payments is relatively straightforward as a concept, its application has proven challenging.

The primary issue under the first option is the appropriate discount rate (i.e., interest rate) for calculating the present value of the deferred cash payments to ensure that the secured creditor receives total distributions under the plan equal to the allowed amount of its secured claim as of the effective date of the plan. The objective is to make sure payments received by the secured creditor in the future represent the value of its secured claim on the effective date (following the general principle that a dollar received today is more than a dollar received tomorrow). The discount rate used by the court affects the amount of deferred cash payments required under the plan to satisfy section 1129(b)(2)(A)(i).

There are several approaches to determining an appropriate discount rate for purposes of section 1129(b)(2)(A)(i), including the "formula" approach (also referred to as the "prime plus" approach), the "coerced loan" approach, the cost of funds approach, and the "presumptive contract rate" approach. Prior to 2004, courts applied different approaches, often based on the circumstances of the case before it. Nevertheless, in 2004, the Supreme Court adopted the formula approach for purposes of a chapter 13 plan in *Till v. SCS Credit Corp.*[844] Specifically, the Supreme Court determined that for purposes of calculating the present value of deferred cash payments to a secured creditor under a chapter 13 plan, a court should use the risk-free rate of interest at the time of the determination, adjusted by 100 to 300 basis points to account for the risk of default in the given case, the nature and quality of the collateral, and the duration and feasibility of the chapter 11 plan.[845]

In *Till*, the Supreme Court was faced with a consumer loan used by the chapter 13 debtors to purchase a truck prior to the petition date. At the time of the plan, the debtors owed approximately $4,895 to the lender, and the truck was valued at approximately $4,000. A plurality of the Supreme Court determined that the formula or prime plus approach was simple, cost-effective, and the most appropriate approach for determining the present value of the proposed deferred cash payments to the lender under the plan. As observed by the Court, "[u]nlike the other approaches proposed in this case, the formula approach entails a straightforward, familiar, and objective inquiry, and minimizes the need for potentially costly additional evidentiary hearings."[846]

Although the Supreme Court noted that its decision was limited to the chapter 13 context, and some dicta in the decision suggest that the analysis may be quite different

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[844] Till v. SCS Credit Corp., 541 U.S. 465 (2004).
[845] *Id.*
[846] *Id.*

for chapter 11 cases,[847] some courts have followed the *Till* formula approach for purposes of section 1129(b)(2)(A)(i).[848] For example, in *In re MPM Silicones LLC*, the court adopted the *Till* formula approach in the chapter 11 context, noting that the Supreme Court had specifically rejected the coerced loan approach in *Till* because that approach required courts to consider market rates and such rates might include profit components not available in bankruptcy.[849] In so holding, the *MPM Silicones* court placed little value on the Supreme Court's dicta in *Till*.

Other courts and commentators have criticized the use of a formula approach in chapter 11 cases.[850] These commentators focus on the differences in debt instruments and assets in a chapter 11 and a chapter 13 case, and that an efficient market is more readily ascertainable for chapter 11 debt. They further argue that *Till*'s oversimplified approach to the present value calculation frequently undervalues the secured creditor's claim. Finally, critics suggest that the application of the formula approach to chapter 11 cramdown payments could negatively impact distressed debt markets and the liquidity that flows from those markets.

b. Cramdown Interest Rates: Recommendations and Findings

The Commission recognized the uncertainty created by the Supreme Court's decision in *Till* and the different interpretations of that decision by lower courts. The Commissioners discussed the potential methods for calculating present value for purposes of cramdown under section 1129(b)(2)(A)(i). Some of the Commissioners found the simplicity and certainty of the *Till* formula approach attractive. Other Commissioners argued for use of market comparables, recognizing that a market typically will exist for the kinds of debt instruments and the businesses/assets at issue in

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[847] For example, the Supreme Court notes the following in a footnote:

> This fact helps to explain why there is no readily apparent Chapter 13 "cram down market rate of interest": Because every cram down loan is imposed by a court over the objection of the secured creditor, there is no free market of willing cram down lenders. Interestingly, the same is not true in the Chapter 11 context, as numerous lenders advertise financing for Chapter 11 debtors in possession. Thus, when picking a cram down rate in a Chapter 11 case, it might make sense to ask what rate an efficient market would produce. In the Chapter 13 context, by contrast, the absence of any such market obligates courts to look to first principles and ask only what rate will fairly compensate a creditor for its exposure.

Id. at 476 n.14 (citing to websites advertising debtor in possession lending).

[848] *See, e.g.*, *In re* Tex. Grand Prairie Hotel Realty, L.L.C., 710 F.3d 324 (5th Cir. 2013); *In re* Mendoza, 2010 WL 1610120 (Bankr. N.D. Cal. Apr. 20, 2010); *In re* Princeton Office Park, L.P., 423 B.R. 795 (Bankr. D.N.J. 2010); *In re* Price Funeral Home, Inc., 2008 WL 5225845 (Bankr. E.D.N.C. Dec. 12, 2008); *In re* Deep River Warehouse, Inc., 2005 WL 2319201 (Bankr. M.D.N.C. Sept. 22, 2005); *In re* Field, 2005 WL 3148287 (Bankr. D. Idaho Oct. 17, 2005).

[849] *In re* MPM Silicones, LLC, 2014 WL 4436335 (Bankr. S.D.N.Y. Sept. 9, 2014) (explaining that cramdown is intended to "put the creditor in the same economic position it would have been in had it received the value of its allowed claim immediately . . . the value of a creditor's allowed claim does not include any degree of profit").

[850] *See, e.g.*, Bank of Montreal v. Official Comm. of Unsecured Creditors (*In re* Am. HomePatient, Inc.), 420 F.3d 559 (6th Cir. 2005), *cert. denied*, 549 U.S. 942 (2006); Gen. Elec. Credit Equities, Inc. v. Brice Rd. Devs., L.L.C. (*In re* Brice Rd. Devs., L.L.C.), 392 B.R. 274, 280 (B.A.P. 6th Cir. 2008); *In re* DBSD N. Am., Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff 'd*, 2010 WL 1223109 (S.D.N.Y Mar. 24, 2010), *aff 'd in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010); *In re* Good, 413 B.R. 552 (Bankr. E.D. Tex. 2009), *aff 'd sub nom.* Good v. RMR Invs., Inc., 428 B.R. 249 (E.D. Tex. 2010); *In re* Winn-Dixie Stores, Inc., 356 B.R. 239 (Bankr. M.D. Fla. 2006).

chapter 11 cases. Still other Commissioners suggested a hybrid approach that would establish a formula to guide the court's determination, but that would consider factors more relevant to chapter 11 cases. For example, the court could consider the weighted average cost of capital component for the particular tranche of debt at issue in the discounted cash flow valuation accepted by the court for purposes of determining the debtor's enterprise value in connection with confirmation of the chapter 11 plan.

The Commissioners did not try to decipher the Supreme Court's holding or dicta in *Till*; rather, they focused on the purpose of section 1129(b)(2)(A)(i) and the best method to achieve that objective. The Commission agreed that the section was intended to provide the secured creditor with the value of its allowed secured claim as of the effective date of the plan, even if that amount would be paid over an extended period of time. In other words, the secured creditor should receive the same return, regardless of whether the debtor elects to pay the allowed secured claim in cash on the effective date or through deferred cash payments over several years. Accordingly, the discount rate applied to the deferred cash payments should reflect the economic realities of the case, including the rate of interest available on similar debt and risks associated with the future income stream available to fund the payments. Some of the Commissioners also asserted that any discount rate should factor in the opportunity costs associated with the deferred cash payments.

The Commissioners debated the precise calculation method, discussing each of the potential approaches identified above (i.e., the formula approach, a cost of capital/market comparables approach, and a weighted average cost of capital approach). They generally agreed that it was difficult to develop a one-size-fits-all approach. In some cases, markets may be efficient and provide relevant data; in other cases, markets may be dysfunctional and a prime plus type formula may produce more reliable results. Accordingly, the Commission voted to recommend: (i) clarifying section 1129(b)(2)(A)(i)(II) to emphasize the present value calculation required to implement the purpose of that section; (ii) adopting a general market approach to determining an appropriate discount rate; and (iii) rejecting the *Till* "prime plus" formula.

The Commissioners discussed how courts could best ascertain appropriate market rates in any given case. They examined various factors and approaches. After extensive deliberation, the Commission concluded that, as a general matter, the court should use the cost of capital for similar debt issued to companies comparable to the debtor as a reorganized entity. The Commission further agreed that if a market rate cannot be determined for a particular debtor, the court should use an appropriate risk-adjusted rate that reflects the actual risk posed in the case of the reorganized debtor considering factors such as the debtor's industry, projections, leverage, revised capital structure, and obligations under the plan. The Commission did not find the prime plus formula articulated in *Till* appropriate for business chapter 11 cases, even if an efficient market does not exist. Among other things, the discount rate used in that prime plus formula is not based on the economic realities of the particular case and, consequently, likely undercompensates creditors for the risk present in the postconfirmation credit.

6. Class-Skipping and Intra-Class Discriminating Distributions

Recommended Principles:

- Seniorcreditorsshouldnotbepermittedtomakeclass-skipping,class-discriminating, or intra-class discriminating transfers to junior creditors or interest holders under a chapter 11 plan if such transfers would violate the absolute priority rule of section 1129(b)(2)(B)(ii) or section 1129(b)(2)(C)(ii) of the Bankruptcy Code.

a. Class-Skipping and Intra-Class Discriminating Distributions: Background

Creditors frequently contest the debtor's proposed allocation of value and related distributions in the chapter 11 case. These disputes may focus on the valuation of the debtor's assets or business or the validity or priority of creditors' claims. In either scenario, the junior creditors' claims may in fact be entitled to a portion of the value available for distribution in the case, or they may at least have "holdup value." Creditors' claims have holdup value when they have meritorious or colorable claims against the senior creditors and the resolution of those claims is delaying distributions in the case. This potential delay can arise with respect to sale proceeds or in the context of a chapter 11 plan, particularly in the cramdown context under section 1129(b).

Courts are divided as to the permissibility of class-skipping transfers in chapter 11 cases. Some courts view class-skipping transfers as a voluntary arrangement between the senior creditors giving, and the junior creditors receiving, the transfers (also referred to as "gifting" in this context).[851] Once the value of the senior creditors' allowed claims are determined, these courts hold that the senior creditors can use or allocate that value in any manner suitable to them. The working assumption underlying these cases is that the senior creditors are using their own money to pay the junior creditors so the estate is not harmed. To the contrary, many commentators and some courts assert that class-skipping gifts lead to efficient resolutions and foster the bankruptcy policy of consensual plans.[852]

Other courts refuse to approve class-skipping transfers.[853] These courts focus on the purpose of the absolute priority rule and view class-skipping transfers as a workaround of the Bankruptcy Code's confirmation standards. They also raise concerns regarding self-enrichment and collusive activities that can benefit some stakeholders at the expense of others who do not have sufficient bargaining power to participate in the negotiations. These courts are also willing to designate the senior creditor's votes under section 1126(e) of the Bankruptcy Code for, among other things, facilitating a payment in contravention of the Bankruptcy Code for its own benefit and to the exclusion or harm of others.

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[851] *See, e.g., In re* SPM Mfg. Corp., 984 F.2d 1305 (1st Cir. 1993) (permitting class-skipping in chapter 7 case). For a discussion of gifting and the *SPM* case, *see* Daniel J. Bussel & Kenneth N. Klee, *Recalibrating Consent in Bankruptcy*, 83 Am. Bankr. L.J. 663, 711 (2009).

[852] *See, e.g., In re* DBSD N. Am., Inc., 419 B.R. 179, 187–88 (Bankr. S.D.N.Y. 2009), *aff'd*, 2010 WL 1223109 (S.D.N.Y Mar. 24, 2010), *aff 'd in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010).

[853] *See, e.g.*, DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79 (2d Cir. 2011); *In re* Armstrong World Indus., 432 F.3d 507 (3d Cir. 2005).

The concerns with class-skipping transfers find their origins in *Northern Pacific Railway Co. v. Boyd*.[854] The *Boyd* case involved an equity receivership of a railroad in which the secured creditors transferred part of their recovery to the pre-petition equity security holders, while unsecured creditors in the case received no recoveries. The U.S. Supreme Court held that "[a]ny device . . . whereby stockholders were preferred before the creditor was invalid [under the Bankruptcy Act]."[855] Accordingly, *Boyd* is one of the key cases in the development of the absolute priority rule and the fair and equitable standard used in the cramdown context under section 1129(b) of the Bankruptcy Code.[856] Supreme Court cases addressing the absolute priority rule under the Bankruptcy Code focus primarily on whether equity security holders can receive distributions under a plan on account of new value contributed to the plan.[857]

b. Class-Skipping and Intra-Class Discriminating Distributions: Recommendations and Findings

Debtors are increasingly seeking to confirm their plans on a nonconsensual basis with one or more classes of creditors. Although consensual plans are the desired result, achieving a fully consensual plan is difficult in cases with valuation disputes and one or more classes of creditors significantly impaired or arguably out of the money. In such cases, allowing senior creditors to pay a small gift or tip to junior creditors can resolve objections to plan confirmation, facilitate the debtor's reorganization, and disperse value further down the debtor's capital structure.[858] From this perspective, the absolute priority rule can be viewed as frustrating distribution to junior creditors. The Commission studied the impact of the absolute priority rule in a variety of circumstances in chapter 11 cases.

The Commissioners recognized the high hurdle frequently posed by the absolute priority rule and the fair and equitable standard in cramdown cases. They considered eliminating the absolute priority rule or adopting a relative priority standard. They evaluated academic articles discussing these alternatives, as well as an in-depth report on these articles and the related issues from the advisory committee. The Commissioners generally favored lowering barriers to confirmation of feasible plans,

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[854] N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913).

[855] *Id.* at 504.

[856] *See also In re* Iridium Operating LLC, 478 F.3d 452, 463 n. 17 (2d Cir. 2007) ("The absolute priority rule originated as a 'judicial invention designed to preclude the practice in railroad reorganizations of 'squeezing out' intermediate unsecured creditors through collusion between secured creditors and stockholders (who were often the same people.'")) (citations omitted).

[857] *See* Bank of Am. Nat'l Trust & Sav. Ass'n v. 203 N. LaSalle St. P'ship, 526 U.S. 434, 437 (1999); Norwest Bank Worthington v. Ahlers, 485 U.S. 197, 206 (1988). The Second Circuit has interpreted these cases as endorsing a strict interpretation of the absolute priority rule. *See* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 97 (2d Cir. 2011).

[858] *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 15 (Nov. 15, 2012) ("CFA believes that senior creditors should be permitted to reallocate their recovery to junior classes because doing so would foster the reorganization process, even if it means skipping out-of-the-money junior classes. The law should favor efficient ventures between managers and senior lenders and encourage reorganizations that share in the growth in the value of the debtor. Accordingly, CFA encourages the Commission to reexamine the prohibition against 'gift' plans."), *available at* Commission website, *supra* note 55.

particularly if such plans provided distributions to more creditors. They were not willing to do so, however, at the expense of creditor priorities or appropriate checks on self-interested behavior and undue influence by creditors.

In the context of class-skipping transfers (i.e., nonconsensual gifting), the Commissioners reviewed the historical underpinnings of the absolute priority rule. They debated the policies underlying the Supreme Court decisions in *Boyd*[859] and *Los Angeles Lumber*.[860] The Commissioners weighed the benefits of using class-skipping transfers to facilitate confirmation against concerns regarding senior creditors imposing their will or unduly influencing plan negotiations if payments outside of the strict priority waterfall were permitted. They also discussed recent cases in which gifting was either permitted or denied (including *DBSD*[861] and *Iridium*[862]), and the justifications for variations from the absolute priority rule. The Commission agreed that — in the nonconsensual (i.e., cramdown) context — the potential abuses of gifting outweighed any benefits in class-skipping, class-discriminating, and intra-class discriminating cases. Some of the Commissioners also emphasized the need to define the phrase "under a chapter 11 plan" broadly to prohibit direct or indirect gifting under plans.

D. Disclosure and Use of Postconfirmation Entities and Claims Trading

Recommended Principles:

- "Adequate information" for purposes of section 1125(a) should include (i) specific information regarding the governance of, and assets being transferred to, the reorganized debtor, any successor to the debtor, or any postconfirmation entity (including any litigation trust), as well as drafts of the operative documents; (ii) the mechanics for resolving claims and making distributions postconfirmation to holders of claims and interests under the chapter 11 plan; and (iii) the procedures for parties to raise and resolve any postconfirmation issues relating to the chapter 11 plan or any postconfirmation entity (including a litigation trust).
- The debtor or plan proponent should be permitted to use a postconfirmation entity (including any litigation trust) under a chapter 11 plan only to the extent that the court finds, in connection with the confirmation hearing and order, that the postconfirmation entity (including any litigation trust) and the material terms governing its operation sufficiently protect the interests of the beneficiaries of such entity or trust.
- No change is suggested with respect to the current law governing the trading of claims in a chapter 11 case or the disclosures required by Bankruptcy Rule 2019.

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[859] N. Pac. Ry. Co. v. Boyd, 228 U.S. 482 (1913).

[860] Case v. L.A. Lumber Prods. Co., 308 U.S. 106 (1939).

[861] *See* DISH Network Corp. v. DBSD N. Am., Inc. (*In re* DBSD N. Am., Inc.), 634 F.3d 79, 97 (2d Cir. 2011).

[862] *See* Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007) (holding that "a rigid *per se* rule cannot accommodate the dynamic status of some preplan bankruptcy settlements" but that "whether a particular settlement's distribution scheme complies with the [Bankruptcy] Code's priority scheme must be the most important factor for the bankruptcy court to consider when determining whether a settlement is 'fair and equitable'").

1. Disclosure and Use of Postconfirmation Entities and Claims Trading: Background

a. Disclosure Concerning Postconfirmation Governance and Postconfirmation Entities

Chapter 11 requires a debtor or plan proponent to disclose various information concerning the debtor's business, chapter 11 case, and proposed chapter 11 plan in a disclosure statement.[863] The disclosure statement, together with the proposed plan, must then be approved by the court and distributed to creditors and other stakeholders. The primary purpose of the disclosure statement is to provide stakeholders with adequate information to evaluate and cast a vote on the proposed plan.[864] Specifically, section 1125(b) provides: "An acceptance or rejection of a plan may not be solicited after the commencement of the case under this title from a holder of a claim or interest with respect to such claim or interest, unless, at the time of or before such solicitation, there is transmitted to such holder the plan or a summary of the plan, and a written disclosure statement approved, after notice and a hearing, by the court as containing adequate information."[865]

The key inquiry in assessing a debtor's or plan proponent's disclosure statement is whether it contains adequate information. The Bankruptcy Code defines "adequate information" as follows:

> "[A]dequate 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, including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case, that would enable such a hypothetical investor of the relevant class to make an informed judgment about the plan, but adequate information need not include such information about any other possible or proposed plan and in determining whether a disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost of providing additional information. . . .[866]

Moreover, courts have developed a list of factors to guide their review in this context. These factors consider whether the disclosure statement discusses, among other things (i) the circumstances giving rise to the chapter 11 case; (ii) the debtor's assets and liabilities; (iii) the company's future business plans and the funding sources for those endeavors; (iv) information regarding the chapter 11 case, including claims,

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[863] 11 U.S.C. § 1125.

[864] The legislative history of section 1125 provides: "This section is new. It is the heart of the consolidation of the various reorganization chapters found in current law. It requires disclosure before solicitation of acceptances of a plan of reorganization." H.R. Rep. No. 95-595, at 409 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6365.

[865] 11 U.S.C. § 1125(b).

[866] *Id.* § 1125(a).

litigation, and the condition of the debtor's business; (v) an analysis of recoveries for creditors under the plan and in a hypothetical chapter 7 liquidation; (vi) the debtor's financial condition, a valuation of the business, and projected future performance; (vii) the tax consequences of the plan; and (viii) risks posed to creditors under the plan.[867] Overall, courts assess whether the disclosure statement identifies and explains material aspects of the debtor's business, chapter 11 case, and proposed plan so that creditors and other stakeholders can make an informed decision about voting on the plan.[868]

A key area of discussion in a disclosure statement from the creditors' perspective is often the information provided concerning the future operation of the business and how claims, recoveries, and distributions will be handled postconfirmation. The former is of particular importance in cases in which creditors are receiving equity or another security whose value is dependent on the future success of the business. The latter is crucial when a litigation or liquidation trust (or other postconfirmation entity) is being established to, for example, pursue claims and causes of action that belong to the estate, review claims asserted against the estate, and make distributions to creditors.[869] In both, creditors and the court must receive sufficient information to understand the mechanics of the plan postconfirmation and to determine whether the plan complies with the Bankruptcy Code and other applicable nonbankruptcy law.

b. Disclosure and Role of Claims Trading

The term "claims trading" generally refers to the buying and selling of claims against a bankrupt company. For example, a debtor's supplier may sell its claim for unpaid goods to an investor at a discount in order to monetize its claim quicker and avoid interaction with the bankruptcy case. Investors also actively trade claims they own as lenders, as well as those that they purchase from other creditors. Although the practice of claims trading is not new, it has grown exponentially in recent years. As explained by one industry publication, "A slowdown in large corporate Chapter 11 filings in 2012 didn't stop distressed investors, who bought and sold more than $41 billion worth of bankruptcy claims last year."[870]

Commentators debate the impact of claims trading on chapter 11 cases. Critics suggest that claims trading (i) destabilizes the debtor's reorganization efforts, (ii) removes creditors with a vested interest in the debtor's business from the process, and

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[867] *See, e.g., In re* U.S. Brass Corp., 194 B.R. 420, 424 (Bankr. E.D. Tex. 1996); *In re* Cardinal Congregate I, 121 B.R. 760, 765 (Bankr. S.D. Ohio 1990); *In re* Scioto Valley Mortg. Co., 88 B.R. 168, 170 (Bankr. S.D. Ohio 1988); *In re* Metrocraft Publ'g Servs., Inc., 39 B.R. 567 (Bankr. N.D. Ga. 1984).

[868] *See, e.g., In re* Copy Crafters Quickprint, Inc., 92 B.R. 973, 980 (Bankr. N.D.N.Y. 1988) (denying motion to approve disclosure statement where disclosures were "unsupported by factual information so that voting parties were unable to independently evaluate the merits of the plan") (citations omitted).

[869] For a general explanation of the use and potential issues with postconfirmation entities, *see* Andrew M. Thau et al., *Postconfirmation Liquidation Vehicles (Including Liquidating Trusts and Postconfirmation Estates): An Overview*, 16 Norton J. Bankr. L. & Prac. 201 (2007). *See also* William L. Medford, *Retention of Claims Post-Confirmation: Fifth Circuit Clarifies Necessary Level of Specificity*, Am. Bankr. Inst. J., Dec./Jan. 2012, at 24; Andrew J. Morris, *Clarifying the Authority of Litigation Trusts: Why Post-Confirmation Trustees Cannot Assert Creditors' Claims Against Third Parties*, 20 Am. Bankr. Inst. L. Rev. 589 (2012); Robert M. Quinn, *Not So Fast, Mr. Liquidating Trustee! May Anyone Other Than a Bankruptcy Trustee Exercise Avoidance Powers After Confirmation?*, Am. Bankr. Inst. J., Apr. 2003, at 28.

[870] Dow Jones Daily Bankr. Rev., Jan. 28, 2013.

(iii) provides arbitrage and takeover opportunities for investors that may depress value and harm other creditors.[871] Proponents suggest that claims trading: (i) provides liquidity to, and an efficient exit strategy for, creditors who do not want to be involved in the case, (ii) may consolidate claims against the debtor and minimize the number of stakeholders the debtor must negotiate with to achieve a consensual plan, and (iii) may permit the entry of longer term, well-capitalized investors into a restructuring process through claims purchasing, which may result in increased access to debtor in possession and exit financing.[872] Commentators also assert that the possibility of an early exit and return for creditors increases liquidity overall in capital markets and allows a more forgiving investment environment.

A review of the literature on claims trading reveals that transparency and disclosure are key issues in this debate. To that end, Bankruptcy Rule 2019 was amended in 2011 to increase disclosures by investors that are members of *ad hoc* committees, groups, or investors otherwise acting collectively in the bankruptcy case. Bankruptcy Rule 2019 requires investors in these circumstances to disclose, among other things, their names, addresses, and nature and amount of each "disclosable economic interest" they hold against the debtor. In addition, courts have addressed questionable conduct by investors in the claims trading context through various means, including by reducing the investor's claim, subordinating the investor's claim, or designating the investor's vote on the chapter 11 plan.[873] Commentators continue to debate the utility of claims trading and regulation of the bankruptcy claims trading market.[874]

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[871] *See, e.g.*, Kevin J. Coco, *Empty Manipulation: Bankruptcy Procedure Rule 2019 and Ownership Disclosure in Chapter 11 Cases*, 2008 Colum. Bus. L. Rev. 610 (2008) (discussing potential issues with bankruptcy claims trading and voting in chapter 11); Frederick Tung, *Confirmation and Claims Trading*, 90 NW. U. L. Rev. 1684 (1996) (analyzing advantages and disadvantages for claims trading); Aaron L. Hammer & Michael A. Brandess, *Claims Trading: The Wild West of Chapter 11s*, Am. Bankr. Inst. J., July/Aug. 2010, at 1 ("Despite the vast benefits created by the market, claims trading has also generated negative implications on the structure of the reorganization process.").

[872] *See, e.g.*, *Written Statement of John Greene on behalf of Halcyon Asset Management LLC: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing the value of the distressed debt market for debtors), *available at* Commission website, *supra* note 55; *Written Statement of Jennifer Taylor: WLC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 30, 2012) (same), *available at* Commission website, *supra* note 55; *Written Statement of Professor Edward I. Altman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing liquidity offered by distressed debt markets), *available at* Commission website, *supra* note 55; *Written Statement of Professor Edward I. Altman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (same), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Edith H. Jones, Fifth Circuit Court of Appeals: VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Feb. 21, 2013) (noting that claims trading improves liquidity and reduces risk for traditional lenders), *available at* Commission website, *supra* note 55.

[873] Courts have reduced claim amounts with respect to insiders or other fiduciaries. *See, e.g., In re* MC2 Capital Partners, LLC, Case No. 11-14366 (Bankr. N.D. Cal. Feb. 27, 2013) ("[T]he exception to the general rule that transfers are to be taken at face value applies when the transferee has fiduciary duties to the debtor or the transfer is an attempt to circumvent the consequences of those duties."); Citicorp Venture Capital, Ltd. v. Comm. of Creditors Holding Unsecured Claims (*In re* Papercraft Corp.), 211 B.R. 813, 825 (W.D. Pa. 1997), *aff 'd*, 160 F.3d 982 (3d Cir. 1998); Bernstein v. Donaldson (*In re* Insulfoams, Inc.), 184 B.R. 694 (Bankr. W.D. Pa. 1995), *aff 'd sub nom.* Donaldson v. Bernstein, 104 F.3d 547 (3d Cir. 1997). Equitable subordination is addressed by section 510(c) of the Bankruptcy Code and generally requires some harm (*e.g.*, delay in emergence from bankruptcy or impairment of other creditors) resulting from the alleged inequitable conduct. *See, e.g.*, Shubert v. Lucent Techs. Inc. (*In re* Winstar Commc'ns, Inc.), 554 F.3d 382, 413 (3d Cir. 2009) ("A bankruptcy court should attempt to identify the nature and extent of the harm it intends to compensate in a manner that will permit a judgment to be made regarding the proportionality of the remedy to the injury that has been suffered by those who will benefit from the

2. Disclosure and Use of Postconfirmation Entities and Claims Trading: Recommendations and Findings

a. Disclosure Concerning Postconfirmation Governance and Postconfirmation Entities

The Commissioners discussed the kinds of information necessary to inform stakeholders about key components of the chapter 11 plan. The Commission determined that, as a general matter, debtors and plan proponents provide an acceptable level of disclosures with respect to events leading up to, and occurring during, the chapter 11 case, as well as with respect to the current state of its assets, liabilities, and business. Many of the Commissioners believed, however, that disclosure is frequently insufficient with respect to the governance and operations of the reorganized debtor and any postconfirmation entity established in connection with the plan.

The Commissioners discussed the proliferation of postconfirmation entities in chapter 11 plans. These entities can take a variety of forms, including a litigation trust, a liquidation trust, a postconfirmation business trust, or the reorganized debtor itself when the debtor is no longer operating a business, but is solely winding down the affairs of the estate outside of the bankruptcy process. Section 1123(b) states that a plan may provide for "the settlement or adjustment of any claim or interest belonging to the debtor or to the estate; or . . . the retention and enforcement by the debtor, by the trustee, or by a representative of the estate appointed for such purpose, of any such claim or interest."[875] Debtors and plan proponents generally rely on the language of section 1123(b) to establish a postconfirmation entity under a plan, and courts approving such entities often perceive them as a means to efficiently resolve the chapter 11 case.[876]

The Commissioners recognized the potential utility of postconfirmation entities in facilitating plan implementation and a debtor's emergence from chapter 11. Some of the Commissioners expressed concerns, however, regarding the uncertainty of the postconfirmation entity's authority, governance, operation, and accountability after confirmation of the plan. Although the terms of these entities are set forth in the trust or

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subordination.") (citations omitted). Section 1126(e) provides a mechanism for disqualification (known as "designation") of an acceptance or rejection of a plan if the acceptance or rejection was not obtained in good faith or the vote to accept or reject was not cast in good faith. 11 U.S.C. § 1126(e) ("On request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith or was not solicited or procured in good faith or in accordance with the provisions of this title.").

[874] *See, e.g.*, Adam J. Levitin, *Bankruptcy Markets: Making Sense of Claims Trading*, 4 Brook. J. Corp. Fin. & Com. L. 67 (2010); *Maneuvering in the Shadows of the Bankruptcy Code: How to Invest or Take Over Bankruptcy Companies Within the Limits of the Bankruptcy Code*, 30 Emory Bankr. Dev. J. 73 (2013); Michelle M. Harner, *Activist Distressed Debtholders: The New Barbarians at the Gate?*, 89 Wash. U. L. Rev. 155 (2011).

[875] 11 U.S.C. § 1123(b)(3). *See also In re* Sweetwater, 884 F.2d 1323 (10th Cir. 1989) (explaining that an estate representative under section 1123 "may not be accomplished by unilateral declaration of the debtor in possession").

[876] *See, e.g., In re* Acequia, Inc., 34 F.3d 800 (9th Cir. 1994) ("[The] aim [of section 1123(b)(3)(B)] was to make possible the formulation and consummation of a plan before completion of the investigation and prosecution of causes of action such as those for previous insider misconduct and mismanagement of the debtor. Thus, the statute was in furtherance of the purpose of preserving all assets of the estate while facilitating confirmation of a plan.") (quoting Duvoisin v. East Tenn. Equity, Ltd. (*In re* S. Indus. Banking Corp.), 59 B.R. 638 (Bankr. E.D. Tenn. 1986)).

other organizational documents, those documents are not often filed with the court until immediately before the confirmation hearing, giving parties little time to review the documents and depriving stakeholders of this information before they cast their votes on the plan. Moreover, once the debtor emerges from chapter 11, the court does not actively oversee the operations of the postconfirmation entity. Rather, at most, the court will entertain disputes arising from the operation of the postconfirmation entity if stakeholders request such review and the court has retained jurisdiction under the plan confirmation order. Some of the Commissioners noted that stakeholders frequently do not have the information, or access to the information, necessary to contest the decisions or operation of the postconfirmation entity.

The Commission considered recommending statutory guidelines for any postconfirmation entities. Nevertheless, as the Commissioners started to consider the elements of those guidelines, they quickly determined that a one-size-fits-all rule was not workable in this context and likely would create more litigation than efficiencies. They further determined that an important element underlying the potential problems with postconfirmation entities was disclosure. Parties need to understand, and have an opportunity to assess, the material terms of the postconfirmation entity and the trust or other applicable organizational documents. The Commissioners also noted that these disclosures were just as relevant and useful with respect to the reorganized debtor proposing to continue operations postconfirmation.

Accordingly, the Commission recommended amending section 1125 of the Bankruptcy Code to require specific disclosures concerning: (i) the governance (e.g., individuals or entities managing the entity's affairs, general decision-making process, procedures for changing key personnel and voting protocols, equity security holders' or beneficiaries' rights with respect to governance matters, etc.) and assets of the reorganized debtor or other postconfirmation entity; (ii) the details of the claims and interests dispute, reconciliation, and distribution process; and (iii) the process to raise issues with the court concerning the postconfirmation entity or the implementation of the chapter 11 plan. It also voted to recommend that a debtor or plan proponent be permitted to use a postconfirmation entity, including a litigation trust, only if the court finds, based on the evidence presented at the confirmation hearing, that the entity and its organizational documents provide sufficient protections and procedures for creditors and other beneficiaries relying on the entity for their recoveries in the case.

a. Disclosure and Role of Claims Trading

Claims trading is often identified as a driving force behind the changing chapter 11 landscape. Harvey Miller has posited:

> 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.[877]

Other commentators disagree with this characterization, citing benefits to claims trading such as enhanced liquidity and cost savings associated with quicker case resolutions.[878] The Commissioners likewise expressed varying positions on the value of claims trading, but they all recognized its increasing presence and arguable influence in chapter 11 cases.

The Commissioners discussed both whether increased regulation or increased disclosure would mitigate perceived problems with claims trading and add or help preserve value in chapter 11 cases. The Commission reviewed the changes to Bankruptcy Rule 3001(e) in 1991 and Bankruptcy Rule 2019 in 2011. These two rule changes arguably move in different directions on the issue of claims trading.

Bankruptcy Rule 3001(e) governs the transfer of claims. Specifically, it addresses the mechanics of filing and preserving transferred claims, depending on the timing of the transfer and the kind of claim transferred. The comments to the 1991 amendment to Bankruptcy Rule 3001(e) suggest that it was intended "to limit the court's role to the adjudication of disputes regarding transfers of claims."[879] For example, unlike its predecessor, Bankruptcy Rule 3001(e)(1) does not require the transferor to acknowledge the transfer or to disclose the consideration exchanged in the transfer.[880] The amendments to Bankruptcy Rule 2019, on the other hand, increase the disclosure obligations of certain investors acting collectively in the case. Although not targeted at claims traders *per se*, investors actively engaged in claims trading and potentially taking positions in, or trying to influence, the chapter 11 case are within its scope.

The Commissioners acknowledged the conflicting anecdotal evidence on claims trading and its impact on chapter 11 cases. Some witnesses argued for increased disclosures and restrictions on claims trading itself.[881] Others testified in favor of claims trading.[882] For example, Professor Edith Hotchkiss explained that her "own and other

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[877] Harvey Miller, *Chapter 11 in Transition: From Boom to Bust and Into the Future*, 81 Am. Bankr. L. J. 375, 390 (2007).

[878] *See, e.g., Written Statement of John Greene on behalf of Halcyon Asset Management LLC: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing the value of the distressed debt market for debtors), *available at* Commission website, *supra* note 55. *See also supra* note 872.

[879] *See* Advisory Committee Notes accompanying 1991 Amendment to Bankruptcy Rule 3001(e).

[880] *See, e.g.*, Preston Trucking Co., Inc. v. Liquidity Solutions, Inc. (*In re* Preston Trucking Co., Inc.), 333 B.R. 315 (Bankr. D. Md. 2005), *aff 'd*, 392 B.R. 623 (D. Md. 2008) (finding that court cannot review transfer of claim for insufficient consideration).

[881] *Written Statement of Jonathan C. Lipson: AIRA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–5 (June 7, 2013) (arguing for more disclosures regarding who holds the debtor's debt and what other positions they might have), *available at* Commission website, *supra* note 55; *Oral Testimony of Michael R. ("Buzz") Rochelle: UT Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27–28 (Nov. 22, 2013) (UT Transcript) (stating that the ability of creditors to sell their debt to claims traders can undermine the bankruptcy case), *available at* Commission website, *supra* note 55.

[882] *See Oral Testimony of Professor Anthony J. Casey: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 44–45 (Nov. 7, 2013) (CFRP Transcript) (stating that claims trading is a positive development in bankruptcy), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Edith H. Jones, Fifth Circuit Court of Appeals: VALCON Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Feb. 21, 2013) (claims trading improves liquidity and reduces risk for traditional lenders), *available at* Commission website, *supra* note 55; *Oral Testimony of Jennifer Taylor: ABI WLC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 24 (Nov. 30, 2012) (ABI WLC Transcript)

academic research has shown that this consolidation of claims is associated with more oversight of the process and more efficient reorganizations, evidenced by a greater likelihood of out-of-court restructurings or prepackaged bankruptcies, less time spent in reorganizations, and a greater likelihood that the firm continues as a going concern."[883]

The Commission agreed that a robust secondary market exists for claims trading and that this market enhances liquidity opportunities for both debtors and creditors: it provides an exit strategy for creditors, which can induce credit extensions to potentially distressed companies in the first instance. As such, the Commissioners generally perceived little benefit to increased regulation of claims trading activities. They did, however, debate whether increased disclosure requirements could benefit parties in the chapter 11 case and those traded on the secondary markets. They considered, for example, extending the Bankruptcy Rule 2019 disclosures to all creditors, perhaps limited to those filing pleadings in connection with a section 363 sale, a plan, a post-petition financing facility, or a motion to appoint a trustee or examiner. The Commissioners examined the purpose and use of any additional disclosures by claims traders in the case. Many of the Commissioners believed that in many circumstances, what an investor paid for a claim or why it purchased the claim would be irrelevant to the merits or substantive legal issues in a dispute in the case. These Commissioners further noted that when price or motive may matter, courts already have means to determine and sanction inappropriate conduct through the claims subordination and vote designation processes.

On balance, the Commission found nominal value to these additional disclosures. The Commission also rejected any specific restrictions on claims trading or the participation of claims traders in chapter 11 cases, particularly in light of the Commission's recommended clarification to vote designation under section 1126(e) of the Bankruptcy Code.

E. General Plan Content

1. Default Plan Treatment Provisions

Recommended Principles:

- A debtor or plan proponent should not be permitted to provide in its chapter 11 plan that, if a class of claims or interests does not vote on the plan, such class is deemed to have accepted the plan for all purposes.

(suggesting that transparency and disclosure in the claims trading market would likely have a significant negative impact on the secondary debt market), *available at* Commission website, *supra* note 55; *Written Statement of Professor Edward I. Altman: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (describing liquidity offered by distressed debt markets), *available at* Commission website, *supra* note 55; *Written Statement of Jennifer Taylor: WLC Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 30, 2012) (describing the value of the distressed debt market for debtors), *available at* Commission website, *supra* note 55; *Written Statement of John Greene on behalf of Halcyon Asset Management LLC: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) (same), *available at* Commission website, *supra* note 55.

[883] *Oral Testimony of Professor Edith Hotchkiss: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 35 (Oct. 17, 2012) (LSTA Transcript), *available at* Commission website, *supra* note 55.

- A debtor or plan proponent should be able to provide default treatment in the chapter 11 plan for any executory contracts and unexpired leases not specifically assumed or rejected under the Bankruptcy Code. If the chapter 11 plan does not provide such default treatment, executory contracts and unexpired leases not otherwise assumed or rejected under section 365 or, for collective bargaining agreements, section 1113 should be permitted to "ride through" the chapter 11 case and be unaffected by the section 1141 discharge. Section 1123 should be amended to implement this change.

a. Default Plan Treatment Provisions: Background

A chapter 11 plan may include provisions that specify the treatment under the plan of certain actions or nonactions by the debtor or other parties. Two common provisions include: (i) a statement that classes of creditors or interest holders not voting on the plan are deemed to accept the plan; and (ii) either the assumption or rejection of executory contracts and unexpired leases not otherwise assumed or rejected prior to the confirmation of the plan. These provisions enable a debtor or plan proponent to articulate bright-line rules for areas of uncertainty under the Bankruptcy Code and applicable law, but the permissibility and consequences of the provisions are less clear.

Section 1129(a)(8) of the Bankruptcy Code requires that each class of claims or interests accept the plan or remain unimpaired under the plan in order for the debtor or plan proponent to obtain confirmation. In addition, under sections 1129(a)(10) and 1129(b) as currently written, a debtor or plan proponent can seek to cram down a plan on objecting creditors and interest-holders only if, among other things, at least one impaired class of claims has accepted the plan. A debtor or plan proponent thus may include a provision in the plan purporting to treat classes of claims or interests that do not vote on the plan as accepting the plan. This situation may arise when creditors or equity security holders in the class simply do not submit ballots indicating acceptance or rejection of the plan.

Section 1126(c) of the Bankruptcy Code states that a class of claims or interest-holders accepts a plan if two-thirds in amount and a majority in number of those voting submit votes in favor of the plan.[884] Bankruptcy Rule 3018(c) provides in relevant part that "acceptance or rejection [of the plan] shall be in writing, identify the plan or plans accepted or rejected, be signed by the creditor or equity security holder or an authorized agent, and conform to the appropriate Official Form."[885] Notably, the courts are split as to whether these provisions permit the plan to deem creditor silence as acceptance of the plan. For example, courts in the Second, Third, and Tenth Circuits tend to follow the Tenth Circuit's decision in *Ruti-Sweetwater*, in which the court held that inaction by a single-creditor class with respect to the plan could be treated as an acceptance for purposes of section 1129(a)(8).[886] Other courts have rejected the *Ruti-Sweetwater*

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[884] 11 U.S.C. § 1126(c).

[885] Fed. R. Bankr. P. 3018(c).

[886] Heins v. Ruti-Sweetwater, Inc (*In re* Ruti-Sweetwater, Inc.), 836 F.2d 1263 (10th Cir. 1988). "The general rule is that the acceptance of the plan by a secured creditor can be inferred by the absence of an objection." *In re* Szostek, 886 F.2d 1405, 1413 (3d Cir. 1989). *See also In re* Accuride Corp., 2010 WL 5093173, at *6 (Bankr. D. Del. Feb. 18, 2010); *In re* DBSD N. Am., Inc., 419 B.R. 179 (Bankr. S.D.N.Y. 2009), *aff 'd*, 2010 WL 1223109

approach, highlighting that the Bankruptcy Code expressly addresses "deemed acceptance" and permits it only in the case of unimpaired classes.[887]

Similar uncertainty exists in the context of executory contracts and unexpired leases not expressly assumed, assigned, or rejected by the trustee[888] prior to plan confirmation. Section 365(d)(2) provides that the trustee may assume, assign, or reject executory contracts and some kinds of unexpired leases "at any time before the confirmation of a plan."[889] Unlike in the chapter 7 context,[890] however, the Bankruptcy Code does not state what happens in the chapter 11 context to contracts or leases not assumed or rejected prior to confirmation, other than with respect to nonresidential real property leases.[891]

In many cases, a debtor or plan proponent will include a default provision that provides for the deemed assumption or rejection of executory contracts or unexpired leases not otherwise expressly assumed or rejected prior to confirmation. If the plan is silent, however, the question arises whether such contracts and leases can "ride through" the chapter 11 case and remain enforceable postconfirmation. Under the ride-through doctrine, "executory contracts that are neither affirmatively assumed or rejected by the debtor under section 365, pass through bankruptcy unaffected."[892] Many courts considering the issue have endorsed the ride-through doctrine,[893] finding it consistent both with the permissive language of section 365(a) (i.e., a trustee may assume or reject executory contracts and unexpired leases) and the revesting of estate property in the debtor postconfirmation under section 1141(b).[894] Nevertheless, the Bankruptcy Code does not expressly authorize the ride-through doctrine. It also can create unexpected consequences for the reorganized debtor and the counterparty, including ongoing

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(S.D.N.Y Mar. 24, 2010), *aff 'd in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010); *In re* Adelphia Commc'ns Corp., 368 B.R. 140 (Bankr. S.D.N.Y. 2007), *appeal dismissed, stay vacated*, 2007 WL 7706743 (2d Cir. Feb. 9, 2007).

[887] *See, e.g.*, *In re* M. Long Arabians, 103 B.R. 211, 216 (B.A.P. 9th Cir. 1989); *In re* Vita Corp., 380 B.R. 525, 528 (C.D. Ill. 2008); *In re* Castaneda, 2009 WL 3756569 (Bankr. S.D. Tex. Nov. 2, 2009); *In re* Jim Beck, Inc., 207 B.R. 1010, 1015 (Bankr. W.D. Va. 1997), *aff 'd*, 214 B.R. 305 (W.D. Va. 1997), *aff 'd*, 162 F.3d 1155 (4th Cir. 1998); *In re* Higgins Slacks Co., 178 B.R. 853, 855 (Bankr. N.D. Ala. 1995); *In re* Adkisson Vill. Apts. of Bradley Cty., Ltd., 133 B.R. 923 (Bankr. S.D. Ohio 1991); *In re* Townco Realty, Inc., 81 B.R. 707, 708 (Bankr. S.D. Fla. 1987).

[888] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

[889] 11 U.S.C. § 365(d)(2).

[890] Section 365(d)(1) provides: "In a case under chapter 7 of this title, if the trustee does not assume or reject an executory contract or unexpired lease of residential real property or of personal property of the debtor within 60 days after the order for relief, or within such additional time as the court, for cause, within such 60-day period, fixes, then such contract or lease is deemed rejected." 11 U.S.C. § 365(d)(1).

[891] Under section 365(d)(4), a trustee has 120 days, plus potentially one 90-day extension, to assume, assign, or reject unexpired leases on nonresidential real property. If the trustee fails to act, such leases are deemed rejected. 11 U.S.C. § 365(d)(4).

[892] *In re* Hernandez, 287 B.R. 795, 799 (Bankr. D. Ariz. 2002). *See also In re* Polysat, Inc., 152 B.R. 886, 890 (Bankr. E.D. Pa. 1993).

[893] *See, e.g.*, Stumpf v. McGee (*In re* O'Connor), 258 F.3d 392, 404 (5th Cir. 2001); Bos. Post Rd. Ltd. P'ship v. FDIC (*In re* Bos. Post Road Ltd. P'ship), 21 F.3d 477, 484 (2d Cir. 1994), *cert. denied*, 513 U.S. 1109 (1995); Pub. Serv. Co. of N.H. v. N.H. Elec. Coop., Inc. (*In re* Public Serv. Co. of N.H.), 884 F.2d 11, 14–15 (1st Cir. 1989).

[894] Section 1141(b) provides: "Except as otherwise provided in the plan or the order confirming the plan, the confirmation of a plan vests all of the property of the estate in the debtor." 11 U.S.C. § 1141(b).

performance obligations for the debtor and a loss of rights in the chapter 11 case for the counterparty.[895]

b. Default Plan Treatment Provisions: Recommendations and Findings

The Commissioners discussed the cost of uncertainty in the plan-confirmation context. Such uncertainty can not only slow down plan negotiations, but it can also impact the prospective business of the reorganized debtor operating, at least in part, under the terms of the confirmed plan. In this context, the Commissioners discussed the appropriate treatment of (i) classes of claims and interests that are entitled to vote on the plan but take no action; and (ii) executory contracts and unexpired leases not otherwise assumed or rejected in the chapter 11 case.

The Commission reviewed the split in the courts regarding the ability to deem silence as acceptance for purposes of section 1129(a)(8) and (a)(10) and section 1129(b). Many of the Commissioners found the reasoning of courts rejecting the Tenth Circuit's approach in *Ruti-Sweetwater* persuasive. These Commissioners noted that Congress knew how to provide for deemed acceptance, as evidence in the unimpaired claim context. Section 1126(e) states: "Notwithstanding any other provision of this section, a class that is not impaired under a plan, and each holder of a claim or interest of such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required."[896] Other Commissioners emphasized the policy considerations articulated by the Tenth Circuit and courts following *Ruti-Sweetwater*: "To hold otherwise would be to endorse the proposition that a creditor may sit idly by, not participate in any manner in the formulation and adoption of a chapter 11 plan and thereafter, subsequent to the adoption of the plan, raise a challenge to the plan for the first time."[897] These courts also observe that treating inaction as rejection makes the deadlines for rejecting a plan or filing objections meaningless.[898]

In considering the competing issues on silence as deemed acceptance, the Commissioners discussed reasons why creditors may not vote. These reasons could include that the creditor is unfamiliar with the bankruptcy process or uninformed regarding the consequences of voting or not voting, the creditor may make a cost-

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[895] *See, e.g., In re* Greystone III Joint Venture, 995 F.2d 1274 (5th Cir. 1992), *cert. denied*, 506 U.S. 821 (1992), *cert. denied*, 506 U.S. 822 (1992) (holding that a nondebtor party to a contract riding through bankruptcy case has no claim against the estate and thus no right to vote on plan); *In re Cochise College Park, Inc.*, 703 F.2d 1339, 1352 (9th Cir. 1983), *superseded by statute*, Bankruptcy Code, *as recognized by In re* Sturgis Iron & Metal Co., Inc., 420 B.R. 716, 726 n. 23, 737 n. 44 (Bankr. W.D. Mich. 2009) (holding that executory contract not otherwise assumed or rejected "continues in effect and the nonbankrupt party . . . is not a creditor with a provable claim against the bankrupt estate").

[896] 11 U.S.C. § 1126(f). *See also* 7 Collier on Bankruptcy ¶ 1126.04 (suggesting that the holding in *Ruti-Sweetwater* was incorrect).

[897] Heins v. Ruti-Sweetwater, Inc (*In re* Ruti-Sweetwater, Inc.), 836 F.2d 1263, 1266 (10th Cir. 1988).

[898] *Id.* at 1266–67. *See also In re* Adelphia Commc'ns Corp., 368 B.R. 140, 216–62 (Bankr. S.D.N.Y. 2007), *appeal dismissed, stay vacated*, 2007 WL 7706743 (2d Cir. Feb. 9, 2007) ("Regarding nonvoters as rejecters runs contrary to the [Bankruptcy] Code's fundamental principle, and the language of section 1126(c), that only those actually voting be counted in determining whether a class has met the requirements, in number and amount, for acceptance or rejection of a plan, and subjects those who care about the case to burdens (or worse) based on the inaction and disinterest of others.").

benefit decision to abstain from voting, the creditor may be agnostic about the overall plan, the creditor may not like contingencies associated with an affirmative vote on the plan (such as a consent to a release), or the creditor may inadvertently fail to timely submit a ballot. The Commissioners did not necessarily believe that creditors should be deemed to accept a plan in all of these circumstances. Moreover, the Commissioners found it impracticable to suggest a case by-case or creditor-by-creditor analysis in these situations. Accordingly, the Commission agreed that the better rule is to prohibit a plan from providing for "deemed acceptance" if an impaired class of claims fails to vote on a plan. The Commissioners also noted that the import of deemed acceptance would be reduced under these principles, given the Commission's recommendations to eliminate the need for an accepting impaired class for cramdown purposes and the introduction of redemption option value into the cramdown analysis.[899]

The Commission also considered the most appropriate treatment for executory contracts and unexpired leases that are not otherwise assumed or rejected prior to confirmation in accordance with section 365(d)(2). The Commissioners commented that this issue most often arises by surprise — at or after confirmation, the reorganized debtor discovers an executory contract or unexpired lease, or the counterparty finally comes to discover the debtor's chapter 11 case, and the parties are trying to deal with the impact, if any, of the debtor's chapter 11 case on that contractual relationship. The Commissioners articulated the different approaches for handling these situations. For example, the Bankruptcy Code could provide that all executory contracts and unexpired leases not otherwise assumed or rejected by confirmation are deemed rejected. Alternatively, the Bankruptcy Code could provide for deemed assumption in such cases. The Commissioners noted that, under either of those default rules, the rule could produce significant unintended consequences for the debtor or the counterparty. In particular, deemed rejection could result in the debtor or counterparty unknowingly losing rights and access to products, services, or receivables necessary to the reorganized business. Accordingly, the Commission agreed that the better default rule was the ride-through doctrine, which is consistent with how nonexecutory contracts are treated and would preserve the parties' rights, whatever those may be, for further negotiation. In addition, the Commission agreed that the Bankruptcy Code should expressly allow the debtor or plan proponent to alter this default rule and specifically provide for deemed assumption or rejection in its particular case.

2. Exculpatory Clauses

Recommended Principles:

- A debtor or plan proponent should be permitted to include an exculpatory clause in the chapter 11 plan that covers parties participating in the chapter 11 case and identified in the chapter 11 plan, including estate representatives, subject to customary exclusions consistent with public policy, that provides for exculpation with respect to acts or omissions during the case and prior to the

[899] *See* Section VI.F.1, *Class Acceptance Generally and for Cramdown Purposes*; Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.

> effective date of the plan, including in connection with the negotiation, drafting, and solicitation of the plan. Confirmation of the chapter 11 plan under section 1129 should also include the approval and authorization of such permissible exculpatory clauses, provided that adequate disclosure of the scope of, and parties covered by, the exculpatory clause is included in the disclosure statement and the plan. Sections 1125(e) and 1129 should be amended accordingly.

a. Exculpatory Clauses: Background

A chapter 11 plan is in many respects a contract between the debtor or the plan proponent and the debtor's stakeholders. As in other contractual settings, courts have permitted parties to include provisions that exculpate the debtor's directors, officers, similar managing persons, and professionals; the unsecured creditors' committee and its professionals; and certain other parties with respect to conduct occurring during the chapter 11 case and prior to the effective date of the plan. Notably, exculpatory clauses differ from estate or third-party releases that may also be included in a chapter 11 plan. (Third-party releases are discussed below.) A release generally is a relinquishment of claims and causes of action that the debtor or third parties may have against certain nondebtor parties. An exculpatory clause is more akin to limited immunity for the identified parties for conduct during the chapter 11 case.

The Bankruptcy Code does not specifically address the inclusion of exculpatory clauses in chapter 11 plans. Nevertheless, courts tend to approve exculpation when it is reasonable considering the specific circumstances of the case.[900] For example, one court has held that exculpatory clauses are more likely to be reasonable when the conduct covered has already occurred, the exculpatory clause was clearly contained in the plan, and parties entitled to vote have accepted the plan.[901] Another court has found an exculpatory clause reasonable when it was narrowly tailored, exculpated only negligent conduct, and was in the best interests of the estate.[902] Nevertheless, some courts have rejected exculpatory clauses outright, particularly in the context of professionals retained during the bankruptcy case.[903]

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[900] *See, e.g.*, Unsecured Creditors' Comm. v. Pelofsky (*In re* Thermadyne Holdings Corp.), 283 B.R. 749, 755–56 (B.A.P. 8th Cir. 2002) (noting there is no *per se* rule that indemnification and exculpation provisions are impermissible under section 328(a) and holding that the provisions were unreasonable in this particular case); *In re* Metricom, Inc., 275 B.R. 364, 371 (Bankr. N.D. Cal. 2002) (holding that indemnity and exculpation provisions must be reasonable under the circumstances and "such a determination can only be made on a case by case basis"). *See also In re* Comdisco, Inc., 2002 WL 31109431 (N.D. Ill. 2002); *In re* DEC Int'l, Inc., 282 B.R. 423 (W.D. Wis. 2002); *In re* Friedman's, Inc., 356 B.R. 758, 762 (Bankr. S.D. Ga. 2005) (citing United Artists Theatre Co. v. Walton, 315 F.3d 217 (3d Cir. 2003)). For a more complete discussion and additional case citations, *see* Kurt F. Gwynne, *Indemnification and Exculpation of Professional Persons in Bankruptcy Cases*, 10 Am. Bankr. Inst. L. Rev. 711 (2002).

[901] *In re* Friedman's, Inc., 356 B.R. 758, 761–63 (Bankr. S.D. Ga. 2005).

[902] Upstream Energy Servs. v. Enron Corp. (*In re* Enron Corp.), 326 B.R. 497, 504 (S.D.N.Y. 2005).

[903] *In re* Drexel Burnham Lambert Grp., Inc., 133 B.R. 13, 27 (Bankr. S.D.N.Y. 1991) ("Simply stated, indemnification agreements are inappropriate") (citing *In re* Realty Trust, 123 B.R. 626, 630–31 (Bankr. C.D. Cal. 1991)). *See generally* Ryan M. Murphy, *Shelter from the Storm: Examining Chapter 11 Plan Releases for Directors, Officers, Committee Members, and Estate Professionals*, 20 J. Bankr. L. & Prac. 4 Art. 7, Sept. 2011 (general review of case law addressing exculpatory clauses).

A typical exculpatory clause may protect the debtor's directors, officers, employees, advisors, and professionals from "incur[ring] any liability to any holder of a Claim or Equity Interest for any act or omission in connection with, related to, or arising out of, the Chapter 11 Cases, the pursuit of confirmation of the Plan, the consummation of the Plan or the Administration of the Plan or the property to be distributed under the Plan, except for willful misconduct or gross negligence."[904] Courts generally find that exculpatory clauses fall outside the scope of section 524(e),[905] which limits the reach of the bankruptcy discharge.[906] They also frequently focus on the policy justifications underlying exculpation, including encouraging parties to engage in the process and assist the debtor in achieving a confirmable plan — actions that committees, committee members, other estate representatives and their professionals, and certain parties (such as key lenders) may not be willing to undertake in the face of litigation risk. As one court observed: "Exculpation provisions are frequently included in chapter 11 plans, because stakeholders all too often blame others for failure to get the recoveries they desire; seek vengeance against other parties; or simply wish to second-guess the decision makers in the chapter 11 case."[907]

b. Exculpatory Clauses: Recommendations and Findings

The Commission holistically reviewed the issues of discharge, releases, and exculpation. The Commissioners viewed exculpation as a targeted provision intended to protect good faith actors with respect to their conduct during the chapter 11 case. They generally agreed with those courts interpreting exculpatory clauses as establishing acceptable (or nonactionable) standards of conduct and not as affecting a waiver of, or injunction against, third-party claims. The Commissioners thus perceived a distinct difference between the contractual standards of conduct and limited immunity of exculpatory clauses and the more encompassing waivers often proposed by third-party releases. Although the Commission agreed that both types of provisions might be permissible in appropriate cases if certain factors were satisfied, it determined that different standards of review were warranted.

The Commission reviewed the potential parties and types of conduct that should be covered by exculpatory clauses. The Commission agreed that estate representatives (e.g., the debtor in possession, a trustee, an estate neutral, unsecured creditors' committees, committee members) and their professionals should be included within exculpatory clauses. It also acknowledged that the facts of particular cases might support the inclusion of other parties who actively engaged in the reorganization or plan process and could be the target of litigation by claimants unhappy with, among other

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[904] *In re* PWS Holding Corp., 228 F.3d 224, 246 (3d Cir. 2000), *aff'g* 1999 WL 33510165 (Bankr. D. Del. Dec. 30, 1999).

[905] Section 524(e) provides: "Except as provided in subsection (a)(3) of this section, discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt." 11 U.S.C. § 524(e).

[906] *See id.* (explaining that exculpation "does not affect the liability of these parties, but rather states the standard of liability under the Code."). *See also In re* Metromedia Fiber Network, Inc., 416 F.3d 136, 227 (2d. Cir. 2005).

[907] *In re* DBSD N. Am., Inc., 419 B.R. 179, 217 (Bankr. S.D.N.Y. 2009), *aff 'd*, 2010 WL 1223109 (S.D.N.Y Mar. 24, 2010), *aff 'd in part, rev'd in part*, 627 F.3d 496 (2d Cir. 2010).

things, the results of the chapter 11 case or their recoveries under the plan. The Commissioners debated objective factors to determine whether a party sufficiently contributed to the process to be included in the exculpatory clause, but determined that a fact-intensive analysis would work best. They also emphasized that this limited immunity was not intended to protect bad actors, but rather to protect only those parties who act in good faith and who should be protected against claims relating to matters that should be resolved once the plan is confirmed and becomes effective.

The Commissioners discussed whether exculpatory clauses should protect the identified parties from simple negligence or something more. The Commission determined that immunity for conduct arguably constituting simple negligence should be subject to exculpation. It was not able to agree on the desirability of allowing exculpation for gross negligence or other standards of conduct, but believed that the parties and the court should make such decisions based on the facts of the case and public policy considerations. The Commission voted to recommend amendments to the Bankruptcy Code to clarify the permissibility of exculpatory clauses consistent with these principles and properly disclosed in the disclosure statement and plan.

3. Third-Party Releases

Recommended Principles:

- A debtor or plan proponent should be permitted to seek approval of third-party releases in connection with the solicitation and confirmation of the chapter 11 plan. Such third-party releases should be clearly and conspicuously highlighted and explained in the plan and the disclosure statement, identifying the proposed scope of, and parties to be covered by, the releases. The court should approve any such third-party releases based on evidence presented at the hearing and in accordance with the factors set forth below.
- In reviewing a proposed third-party release included in a chapter 11 plan, the court should consider and balance each of the following factors: (i) the identity of interests between the debtor and the third party, including any indemnity relationship, and the impact on the estate of allowing continued claims against the third party; (ii) any value (monetary or otherwise) contributed by the third party to the chapter 11 case or plan; (iii) the need for the proposed release in terms of facilitating the plan or the debtor's reorganization efforts; (iv) the level of creditor support for the plan; and (v) the payments and protections otherwise available to creditors affected by the release. In a case involving the application of third-party releases to creditors and interest-holders not voting in favor of the plan, the court should give significant weight to the last of these factors.
- A proposed release of a debtor's affiliates in the chapter 11 plan should be subject to the same review and approval process proposed above for general third-party releases in these principles.

a. Third-Party Releases: Background

A confirmed chapter 11 plan "discharges the debtor from any debt that arose before the date of such confirmation."[908] The discharge voids any judgments, and enjoins collection and similar actions, asserting personal liability against the debtor based on debts discharged under the plan.[909] Section 524(e) also provides that "[a] discharge of a debt of the debtor does not affect the liability of any other entity on, or the property of any other entity for, such debt."[910] Courts and plan proponents often grapple with the scope and application of this limitation under section 524(e) in the context of third-party releases included in a chapter 11 plan. The Bankruptcy Code recognizes an exception to this limitation for debtors establishing trusts for asbestos claimants; in those cases, the court may enter an order enjoining actions against nondebtor parties.[911]

A release provision in a chapter 11 plan essentially relieves the identified nondebtor parties of any liability for any claims or causes of actions that third parties might hold against them. In a chapter 11 plan, a release may seek to cover the debtor's directors and officers, an unsecured creditors' committee and its members, a nondebtor plan proponent, a plan sponsor, the debtor's lenders and their agents, and other parties who may have been actively engaged in the chapter 11 case and perhaps made contributions to the process.[912] The release may encompass any and all claims or causes of action, or resulting liability, of these nondebtor parties. The release may be binding on only those third parties who consent to the release or who vote in favor of (or abstain from voting on) the plan and the release; it may also be binding on all third parties if the release is approved in connection with confirmation of the plan.[913]

Some commentators assert that section 524(e) prohibits all third-party releases, regardless of their scope or the parties purportedly bound by the provision. Two

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[908] 11 U.S.C. § 1141(d)(1)(A).

[909] *Id.* § 524(a). Specifically, section 524(a) provides that a discharge "voids any judgment at any time obtained, to the extent that such judgment is a determination of the personal liability of the debtor with respect to any debt discharged under section 727, 944, 1141, 1228, or 1328 of this title, whether or not discharge of such debt is waived." *Id.*

[910] 11 U.S.C. § 524(e).

[911] 11 U.S.C. § 524(g). *See generally Written Statement of Professor S. Todd Brown, SUNY Buffalo Law School Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 7, 2013) (discussing issues related to resolution of asbestos claims), *available at* Commission website, *supra* note 55.

[912] Nondebtor releases for insiders such as officers and directors may be subject to more rigorous scrutiny, in part because "[t]hose who benefit from this type of release are most likely the ones asserting that the debtor will be irreparably harmed without it." Elizabeth Gamble, *Nondebtor Releases in Chapter 11 Reorganizations: A Limited Power*, 38 Fordham Urb. L.J. 821, 840 (2011) (analogizing to *Spach v. Bryant*, 309 F.2d 886 (5th Cir. 1962) and noting that bankruptcy court must apply "careful attention and special scrutiny when the claimants are officers, directors or stockholders of the corporate bankrupt"). *See also* Hopper v. Am. Nat'l Bank of Cheyenne, Wyo. (*In re* Smith-Chadderdon Buick, Inc.), 309 F.2d 244, 247 (10th Cir. 1962) ("A claim presented by an officer or director of the bankrupt is subjected to rigorous scrutiny and the claimant must prove good faith and fairness in the transaction").

[913] "[T]he provisions of a confirmed plan bind the debtor, any entity issuing securities under the plan, any entity acquiring property under the plan, and any creditor, equity security holder, or general partner in the debtor, whether or not the claim or interest of such creditor, equity security holder, or general partner is impaired under the plan and whether or not such creditor, equity security holder, or general partner has accepted the plan." 11 U.S.C. § 1141(a). *See also* Sharon L. Levin et al., *The* WaMu *Lesson: Craft Your Release Carefully*, Law360, Jan. 28, 2011 (discussing rejection of releases in chapter 11 cases of *Washington Mutual Inc*. and *WMI Investment Corp.*).

circuits, the Ninth and the Tenth, have adopted this strict view of third-party releases.[914] Specifically, the Ninth Circuit has stated: "The bankruptcy court lacks the power to confirm plans of reorganization which do not comply with the applicable provisions of the Bankruptcy Code. . . . This court has repeatedly held, without exception, that section 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors."[915] The Ninth Circuit has, however, recognized that nondebtor releases may be permitted in asbestos claims cases pursuant to specific statutory authority.[916] The Fifth Circuit also appears to be more restrictive than permissive with respect to third-party releases.[917]

The other circuits that have considered the issue focus instead on section 105(a) of the Bankruptcy Code, which gives the court authority to "issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of [the Bankruptcy Code]."[918] These courts are willing to consider and approve third-party releases under appropriate circumstances. To make this determination, these courts undertake a fact-intensive inquiry analyzing factors such as any contractual or consensual basis for the

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[914] *See* Resorts Int'l, Inc. v. Lowenschuss (*In re* Lowenschuss), 67 F.3d 1394, 1402 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996) (holding that section 524(e) precludes bankruptcy courts from discharging the liabilities of nondebtors); Am. Hardwoods, Inc. v. Deutsche Credit Corp. (*In re* Am. Hardwoods, Inc.), 885 F.2d 621, 625 (9th Cir. 1989) (same); Underhill v. Royal, 769 F.2d 1426, 1432 (9th Cir. 1985) ("Section 524(e) precludes discharging the liabilities of nondebtors."). *See also* Landsing Diversified Props.-II v. First Nat'l Bank & Trust Co. of Tulsa (*In re* W. Real Estate Fund, Inc.), 922 F.2d 592, 601 (10th Cir. 1990) (holding that nondebtor release "improperly insulate[s] nondebtors in violation of section 524(e)"), *modified*, Abel v. West, 932 F.2d 898 (10th Cir. 1991).

[915] Resorts Int'l, Inc. v. Lowenschuss (*In re* Lowenschuss), 67 F.3d 1394, 1402 (9th Cir. 1995), *cert. denied*, 517 U.S. 1243 (1996).

[916] *Id.* at 1402 n.6 ("The Bankruptcy Reform Act of 1994 added § 524(g) to the [Bankruptcy] Code. That section provides that in asbestos cases, if a series of limited conditions are met, an injunction issued in connection with a reorganization plan may preclude litigation against third parties.").

[917] The Fifth Circuit view on nondebtor third-party releases and exculpation clauses is less clear. In several cases, the court has rejected such third-party releases, particularly when such releases are nonconsensual. *See, e.g.*, Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 253 (5th Cir. 2009); Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 760 (5th Cir. 1995). However, some Fifth Circuit cases suggest that the court does not categorically disprove of such releases and may approve them in certain limited circumstances. Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229, 253 (5th Cir. 2009) (suggesting that nondebtor releases are "most appropriate as a method to channel mass claims toward a specific pool of assets"); Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 760 (5th Cir. 1995) (suggesting that a release may be approved where the third party nondebtor liability is not extinguished but instead channeled to a settlement fund). *But see* Ad Hoc Group of Vitro Noteholders v. Vitro S.A.B. de C.V. (*In re* Vitro S.A.B. de C.V.), 701 F.3d 1031, 1062 (5th Cir. 2012) (stating that "[the Fifth Circuit] has firmly pronounced opposition to [nonconsensual nondebtor] releases"). The Fifth Circuit's decision in *Vitro* contains very strong language suggesting a complete prohibition on nonconsensual third party releases. Nevertheless, even in *Vitro*, the Fifth Circuit acknowledges that specific, rather than general, third-party releases may be permissible under certain limited circumstances: "We have distinguished other cases for including general, as opposed to specific, releases. As a result, *Republic Supply Co.* provides no guidance where, as here, we are confronted not by a specific release, but by a general release of all the non-debtor subsidiaries." *Id.* at 1068–69 (citations omitted). Accordingly, the Fifth Circuit appears to lean more toward the restrictive approach of the Ninth and Tenth Circuits but may not be as all-inclusive in its prohibition. In addition, the Fifth Circuit has actually approved of releases in some limited circumstances, although the court has utilized different statutory authorization to do so. *See, e.g.*, Bank of N.Y. Trust Co. v. Official Unsecured Creditors' Comm. (*In re* Pac. Lumber Co.), 584 F.3d 229 (5th Cir. 2009) (using section 1103(c) to approve exculpation provisions for members of the creditors' committee but rejecting other release provisions).

[918] *See, e.g.*, MacArthur Co. v. Johns-Manville Corp. (*In re* Johns-Manville Corp.), 837 F.2d 89 (2d Cir. 1988), *cert. denied*, 488 U.S. 868 (1988) (noting that section 105(a) "has been construed liberally to enjoin suits that might impede the reorganization process").

releases, the role and contributions of the nondebtor parties in the chapter 11 case, the protections afforded by the plan for third parties bound by the releases, and whether the releases are necessary for the debtor's effective reorganization. [919]

Courts adopting a permissive approach to third-party releases do not find section 524(e) as impermeable barrier.[920] They generally point out that section 524(e) does not contain "language of prohibition" and thus should not be interpreted to limit the court's power under section 105(a).[921] They also may distinguish the releases based on the facts of the given case, such as when the third party claims subject to the release are not extinguished, but channeled to allow recovery from separate assets, which commonly means the nondebtor did not receive a complete discharge.[922] Notably, some courts have held that the court's power under section 105(a) in the nondebtor release context should be exercised only when there are unique circumstances. The U.S. Supreme Court also has, in dicta, provided an additional factor to consider: whether the claims against the nondebtor third party are derivative of the debtor's wrongdoing.[923]

b. Third-Party Releases: Recommendations and Findings

The Commission considered this basic question: Should the Bankruptcy Code prohibit third-party releases in chapter 11 plans? The Commission agreed that a blanket prohibition on third-party releases was inadvisable. The Commissioners discussed case examples and particular fact patterns in which third-party releases facilitated a confirmable plan and ultimately benefited all stakeholders. They recognized, however, that third-party releases might not be appropriate in every chapter 11 case. For example, a release provision could be overly broad or not really necessary, particularly in cases where the benefits of the release to the estate are nominal, but the harm to creditors is significant. Accordingly, the Commission rejected carte blanche approval of third-party releases, as well as a presumption in favor of such releases.

The Commissioners discussed the competing considerations underlying the third-party release debate. A debtor may need the assistance of nondebtor parties to effect its

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[919] Deutsche Bank AG v. Metromedia Fiber Network, Inc. (*In re* Metromedia Fiber Network, Inc.), 416 F.3d 136, 142 (2d Cir. 2005) ("Courts have approved nondebtor releases when: the estate received substantial consideration; the enjoined claims were 'channeled' to a settlement fund rather than extinguished; the enjoined claims would indirectly impact the debtor's reorganization 'by way of indemnity or contribution'; and the plan otherwise provided for the full payment of the enjoined claims. Nondebtor releases may also be tolerated if the affected creditors consent.") (citations omitted). "But this is not a matter of factors and prongs. No case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique." *Id. See also* Gillman v. Cont'l Airlines (*In re* Cont'l Airlines), 203 F.3d 203, 212 (3d Cir. 2000) (indicating that nondebtor releases may be appropriate in extraordinary cases); Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 761–62 (5th Cir. 1995) (holding that nondebtor releases could be issued because case satisfied "unusual circumstances" requirement; released parties provided substantial consideration to the estate and the release was a key provision of the plan).

[920] *See generally* Ryan M. Murphy, *Shelter from the Storm: Examining Chapter 11 Plan Releases for Directors, Officers, Committee Members, and Estate Professionals*, 20 J. Bankr. L. & Prac. 4 Art. 7, Sept. 2011 (general review of case law addressing third-party releases).

[921] Monarch Life Ins. Co. v. Ropes & Gray, 65 F.3d 973, 979 (1st Cir. 1995) (citations omitted).

[922] Feld v. Zale Corp. (*In re* Zale Corp.), 62 F.3d 746, 760–61 (5th Cir. 1995).

[923] Travelers Indemnity Co. v. Bailey, 557 U.S. 137, 155 (2009) ("Our holding is narrow. We do not resolve whether a bankruptcy court . . . could properly enjoin claims against nondebtor insurers that are not derivative of the debtor's wrongdoing.").

reorganization. This assistance may be in the form of service, collaboration, funding, business commitments, or other means that allow the debtor to achieve its objectives in the chapter 11 case or in its postconfirmation operations. Nondebtor parties may be reluctant to contribute to the plan or the debtor's reorganization efforts if the nondebtor party might be exposed to liability or will have ongoing liability despite confirmation of the chapter 11 plan. On the other hand, limiting creditors' recoveries to those provided under the plan may substantially change the nature of their rights against nondebtor parties, and in turn further reduce their overall recoveries. In these instances, from the creditors' perspective, nondebtor parties may be receiving a windfall at the creditors' expense.

In light of these considerations, the Commission methodically worked through the various issues that arise in the context of third-party releases. The Commissioners started from the premise that consensual third-party releases — those releases binding only on creditors who expressly consent to the release through a vote on the plan that includes consent to the third-party release, a separate indication on the ballot that the creditor consents to the third-party release, or a separate agreement from the creditor in which it consents to the release — should be enforceable. The Commission disagreed with the Ninth and Tenth Circuits' position that contractual agreements between the affected parties regarding a third-party release should not be enforced. The Commissioners found these kinds of contractual agreements outside the scope of section 524(e) and consistent with the underlying policies of the Bankruptcy Code.

The Commissioners then reviewed the different kinds of nonconsensual third-party releases commonly included in chapter 11 plans. The Commissioners observed the challenges in crafting a bright-line test or general approval standard for such nonconsensual releases. They then considered the different tests used by courts to evaluate nonconsensual third-party releases. Specifically, the Commissioners analyzed the multi-factor tests used by the courts in the *Dow Corning* and the *Master Mortgage* cases, respectively. For example, the court in *Dow Corning* stated:

> We hold that when the following seven factors are present, the bankruptcy court may enjoin a nonconsenting creditor's claims against a nondebtor: (1) There is an identity of interests between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete the assets of the estate; (2) The nondebtor has contributed substantial assets to the reorganization; (3) The injunction is essential to reorganization, namely, the reorganization hinges on the debtor being free from indirect suits against parties who would have indemnity or contribution claims against the debtor; (4) The impacted class, or classes, has overwhelmingly voted to accept the plan; (5) The plan provides a mechanism to pay for all, or substantially all, of the class or classes affected by the injunction; (6) The plan provides an opportunity for those claimants who choose not to settle to recover in

> full and; (7) The bankruptcy court made a record of specific factual findings that support its conclusions.[924]

The court in *Master Mortgage* articulated a five-factor test that considers: (1) the identity of interest between the debtor and the third party, usually an indemnity relationship, such that a suit against the nondebtor is, in essence, a suit against the debtor or will deplete assets of the estate; (2) whether the nondebtor has contributed substantial assets to the reorganization; (3) whether the injunction is essential to reorganization; (4) whether a substantial majority of the creditors agree to such injunction — specifically, whether the impacted class or classes have "overwhelmingly" voted to accept the proposed plan treatment; and (5) whether the plan provides a mechanism for the payment of all, or substantially all, of the claims of the class or classes affected by the injunction.[925]

The Commission considered the application of each factor to different scenarios, including the relationship of the factors to nonconsensual releases. It agreed that in the context of nonconsenting creditors or classes of claims, the factors focusing on the contributions of nondebtor parties, percentage recoveries by the affected creditors, and mechanisms established to facilitate recoveries to those creditors were of particular importance, with specific emphasis on the last of these factors. On balance, the Commission recommended a standard based on the *Master Mortgage* factors and rejected application of the *Dow Corning* factors. It further determined that the *Master Mortgage* factors adequately captured the careful review required in these cases and declined to incorporate separate identification of unique or unusual circumstances.

F. Plan Voting and Confirmation Issues

1. Class Acceptance Generally and for Cramdown Purposes

Recommended Principles:

- The numerosity requirement of section 1126(c) of the Bankruptcy Code should be replaced with a "one creditor, one vote" concept. Accordingly, a class of claims should be treated as voting in favor of the chapter 11 plan if the plan is accepted by: (i) creditors (other than an entity designated under section 1126(e)) holding at least two-thirds in amount of the allowed claims in such class; and (ii) more than one-half in number of the creditors (other than an entity designated under section 1126(e)) holding allowed claims in such class. For purposes of this requirement and voting on a plan, (a) a creditor holding separate claims in different capacities (e.g., as an indenture trustee and as an individual creditor) should be able to vote once in each capacity; and (b) the "one creditor, one vote" voting rule includes and aggregates all claims in a particular class held by an entity and its affiliates (as defined in section 101(2)) that are subject to common investment management.

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[924] *In re* Dow Corning Corp., 280 F.3d 648 (6th Cir. 2002), *cert. denied*, 537 U.S. 816 (2002).
[925] *In re* Master Mortg. Inv. Fund Inc., 168 B.R. 930 (Bankr. W.D. Mo. 1994).

- The confirmation of a chapter 11 plan should not require the acceptance of the plan by at least one class of claims impaired under the plan. Accordingly, section 1129(a)(10) should be deleted.

a. Class Acceptance Generally and for Cramdown Purposes: Background

In general, creditors whose rights are impaired by the chapter 11 plan are entitled to vote to accept or reject the plan.[926] Although creditors vote on an individual basis, the plan typically groups claims into classes and proposes particular treatment (e.g., terms and amount of recoveries) for each class. Section 1122(a) provides that "a plan may place a claim or an interest in a particular class only if such claim or interest is substantially similar to the other claims or interests of such class." Accordingly, a debtor or plan proponent attempts to group similarly situated creditors in the same class, though strategic considerations may complicate this analysis.

The classification of claims is important for at least two reasons. First, class acceptance determines creditor support for the plan. Specifically, section 1126(c) provides, "A class of claims has accepted a plan if such plan has been accepted by creditors, other than any entity designated under subsection (e) of this section, that hold at least two-thirds in amount and more than one-half in number of the allowed claims of such class held by creditors, other than any entity designated under subsection (e) of this section, that have accepted or rejected such plan." Second, the debtor or plan proponent generally needs at least one accepting impaired class of creditors to cram down the plan under section 1129(b).

The two requirements of section 1126(c) — i.e., two-thirds in amount and more than one-half in number of allowed claims — set the minimum support required for the class as a whole to accept the plan. If the class accepts and the plan is confirmed, even creditors in the class who voted against the plan, or abstained from voting, are bound by the plan. As such, the level of approval required for class acceptance is often heavily scrutinized and contested. Of the two requirements, the numerosity requirement (more than one-half in number of allowed claims) is the more difficult to interpret and apply in many cases. For example, under appropriate circumstances, a single creditor may exercise more than one vote so long as the court determines that the claims are sufficiently "separate" to warrant more than one vote.[927] The determination of sufficient separateness is based on whether the claims in question derive from independent underlying transactions with the debtor, and whether separate proofs of claim were, or

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[926] 11 U.S.C. § 1126(a), (f) (subsection (a) establishes general rights of holders of claims and interests to vote on plan; subsection (f) provides that unimpaired classes "and each holder of a claim or interest of such class, are conclusively presumed to have accepted the plan, and solicitation of acceptances with respect to such class from the holders of claims or interests of such class is not required").

[927] Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am. (*In re* Figter Ltd.), 118 F.3d 635 (9th Cir. 1997), *cert. denied*, 522 U.S. 996 (1997); *In re* Gilbert, 104 B.R. 206 (Bankr. W.D. Mo. 1989). *See also* Wendell H. Adair, Jr. & Kristopher M. Hansen, *One Claim, One Vote: The Purchase of Claims to Avoid Cramdown*, J. CORP. RENEWAL, Jul. 1, 2000 ("Once again citing the voting formula contained in Section 1126(c) of the Bankruptcy Code, the court held that acceptance or rejection of a plan by a class of creditors is determined by "the number of claims, not the number of creditors, that actually vote for or against a plan."), *available at* http://www.turnaround.org/Publications/Articles.aspx?objectID=1294.

will be, filed for the claims.[928] Notably, this determination may resolve whether the class accepts or rejects the plan.[929]

Similarly, the requirement that one impaired class of creditors accepts the plan under section 1129(a)(10) may prevent a debtor or plan proponent from confirming a plan under the cramdown provisions of section 1129(b). Although some courts and commentators suggest that section 1129(a)(10) was intended to ensure that a plan had some creditor support, neither the legislative history nor the Bankruptcy Code indicate such a purpose.[930] Notably, given the variation in class composition and the different motives and objectives of creditors, a non-accepting class does not necessarily equate to lack of creditor support for the plan. Some commentators have questioned the section's continued utility in light of the barriers to confirmation and the creditor holdup value it creates in many chapter 11 cases.

b. Class Acceptance Generally and for Cramdown Purposes: Recommendations and Findings

The composition of a creditor class for plan purposes can significantly impact a chapter 11 case. A debtor or a plan proponent may consider whether classes can be structured to isolate or dwarf dissenting creditors, or to ensure that creditors supporting the plan dominate the class. Likewise, creditors seeking to delay or disrupt confirmation can raise questions concerning why certain creditors were, or were not, included in a particular class; they also can diversify or strategically purchase claims so that they hold blocking positions in one or more classes. In sum, claims classification and voting under section 1122 and 1126 are subject to significant gamesmanship.[931]

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[928] *See, e.g., In re* Gilbert 104 B.R. 206, 211 (Bankr. W.D. Mo. 1989). *See also* David M. Feldman & Keith R. Martorana, *The Pervasive Problem of Numerosity*, Law360, June 2, 2010, *available at* http://www.gibsondunn.com/publications/Documents/Feldman ThePervasiveProblemOfNumerosity.pdf.

[929] *See In re* Kreider, 2006 Bankr. LEXIS 2948 (Bankr. E.D. Pa. Sept. 27, 2006). In *Kreider*, the creditor class consisted of four American Express funds and five completely unrelated entities; the five unrelated entities voted to accept the plan and the four American Express funds voted to reject the plan. The court rejected the debtor's calculation that the voting resulted in five votes in favor and one against the plan (counting the American Express funds as one vote against the plan). *Id.* at *8–9. The court explained: "[I]t appears that the Debtors' unstated premise — *i.e.*, multiple claims voted by a single creditor are counted as a single vote for purpose of the 'more than one-half in number of allowed claims' requirement for acceptance of a plan set forth in 11 U.S.C. § 1126(c) — is simply incorrect." *Id.* at *9.

[930] *See generally* S. Rep. No. 95-989, at 128 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5914 (stating that at least one class must accept the plan). *See, e.g.*, Clark Boardman Callaghan & Randolph J. Hines, *Bankruptcy Review Commission Fails to Achieve Significant Chapter 11 Reform*, 8 Norton Bankr. L. Adviser 1, Aug. 1997 ("No case law or commentator has identified any important social or reorganization policy that [section 1129(a)(10)] serves. The historical genesis for the requirement reveals it to be a vestigial mutation that serves no evolutionary purpose."); Scott F. Norberg, *Debtor Incentives, Agency Costs, and Voting Theory in Chapter 11*, 46 U. Kan. L. Rev. 507, 537–38 (1998) (noting that neither the legislative report to the 1978 version of the Bankruptcy Code nor 1984 revisions provide insights concerning the purpose of section 1129(a)(10)). *Cf. In re* Windsor on the River Assocs., Ltd., 7 F.3d 127, 131 (8th Cir. 1993) (interpreting legislative history to suggest that the purpose of section 1129(a) (10) "is to provide some indicia of support by affected creditors and prevent confirmation where such support is lacking").

[931] The Commission heard testimony in favor of clarifying the section 1122(a) standard for classification of "substantially similar" claims. *See, e.g., First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 14 (Nov. 15, 2012) ("While the Bankruptcy Code mandates that similarly situated creditors be classified for plan purposes in substantially similar classes, the Code offers no guidance as to how to determine which claims are in fact "substantially similar."

The Commissioners discussed the distraction and diversion of resources caused by this gamesmanship. The Commissioners noted that the original purpose of classification was to provide equal treatment for similarly situated creditors. Likewise, the dollar amount and numerosity requirements of section 1126(c) were intended to protect minority holders. Nevertheless, some of the Commissioners observed that changes in debtors' capital structures and the dynamics of chapter 11 cases arguably decreased the relevance of these objectives. In particular, these Commissioners asserted that a nexus no longer exists between minority protection and the numerosity requirement. A class dominated by smaller claims may face an apathy problem, in which inaction by creditors fails to give any creditor a meaningful voice in the vote.[932] The consolidation of claims by creditors eliminates the "small" or typical minority holder in many cases. In addition, strategic purchases by the same or affiliated entities of "separate" claims can skew the counting for purposes of numerosity.

The anecdotal evidence that the numerosity requirement served, at best, a nominal role in determining class support for a plan persuaded the Commissioners. They considered various alternatives to the numerosity requirement, including the elimination of the voting requirement completely, maintaining the status quo, distinguishing among types of creditors (e.g., financial instrument holders and all others), and introducing additional disclosures to address the perceived empty voting problem, as discussed in Section VI.F.2, *Assignment of Voting Rights*. In discussing the alternatives, the Commissioners found the "one creditor, one vote" rule most democratic and less susceptible to abuse than the current numerosity requirement. Although identifying the "one creditor" for purposes of this requirement may still raise issues, the Commissioners believed that these concerns could be mitigated by treating all affiliated entities under common investment management as a single creditor, and expressly recognizing the different capacities (e.g., indenture trustee and lender) in which a single creditor may hold claims. The Commissioners emphasized that the "common investment management" requirement for aggregation was intended to exclude situations in which affiliates are not only separate entities, but also have different decision-makers overseeing the claims being asserted against the estate. The Commission agreed that the "one creditor, one vote" rule should replace the current numerosity requirement in section 1126(c).

The Commission also considered the impediment to confirmation created by sections 1129(a)(10) and 1129(b), which require at least one accepting impaired class of creditors for the debtor or plan proponent to achieve confirmation through the

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As a result, creditors in general, and secured creditors in particular, do not often get the benefit of their contractual bargain with the debtor. Indeed, it is the debtor who, in the first instance, makes the economic determination of the creditors' rights when it comes to classification of claims based upon the specific prepetition contractual agreements with the debtor, rather than merely whether the claim is secured or unsecured. All too often, factors come into play in determining classification of claims that should be irrelevant, such as motivation of the parties, purchase price and third-party rights."), *available at* Commission website, *supra* note 55.

[932] Wendell H. Adair, Jr., Kristopher M. Hansen, *One Claim, One Vote: The Purchase of Claims to Avoid Cramdown*, J. CORP. RENEWAL, Jul. 1, 2000 ("Once again citing the voting formula contained in Section 1126(c) of the Bankruptcy Code, the court held that acceptance or rejection of a plan by a class of creditors is determined by "the number of claims, not the number of creditors, that actually vote for or against a plan."), *available at* http://www.turnaround.org/Publications/Articles. aspx?objectID=1294.

cramdown provisions of the Bankruptcy Code.[933] The Commissioners debated the utility of section 1129(a)(10), focusing on whether the provision protected creditor interests or simply allowed creditors to hold up the confirmation process. For example, the Commissioners discussed cases with a limited number of impaired creditor classes and a lender or other large creditor who purchases a sufficient number of claims in each class to control the plan vote. By voting against the plan in each of these classes, that single creditor can block a cramdown because there will be no accepting impaired class of creditors for purposes of section 1129(a)(10).

The Commissioners also highlighted issues raised by artificial impairment, in which the debtor or plan proponent strategically grouped claims to achieve at least one accepting impaired class of creditors. Courts are split concerning whether the debtor or plan proponent can achieve impairment of a class through minor changes in the terms of the creditor's claim or repayment rights or whether impairment follows only meaningful economic changes to the debt. For example, the Fifth Circuit (agreeing with the Ninth Circuit, but declining to follow the Eighth Circuit) held that artificial or minor impairment was sufficient for purposes of section 1129(a)(10).[934] The Fifth Circuit noted that such an approach aligned with the policy of encouraging reorganization and that to hold otherwise would be to "shoehorn[] a motive inquiry and materiality requirement into section 1129(a)(10)" that did not exist.[935] As noted by one well-respected commentator: "Congress apparently did not consider the impact of some creditors having more than one vote. [Bankruptcy] Code section 1129(a)(10) causes debtors to attempt to create friendly creditors, to impair creditor classes that need not be impaired and to manipulate classification systems."[936]

The Commissioners acknowledged the potential gating role served by section 1129(a)(10) — ensuring that some creditors whose claims were impaired by the plan supported its confirmation. They discussed the validity of this inquiry and the integrity it potentially added to the confirmation process. They debated the advantages and disadvantages of retaining the requirement, particularly in light of the potential abuses of the section by both creditors and debtors. They considered alternatives, such as retaining section 1129(a)(10) on a per plan basis[937] or only in single asset real estate cases.[938]

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[933] *Written Statement of Daniel Kamensky on Behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("Decisions such as this invite management manipulation of the classification rules for strategic purposes. This, in turn, creates uncertainty regarding creditor recovery and treatment under a plan. This is of particular concern for financial creditors.").

[934] W. Real Estate Equities, L.L.C. v. Vill. at Camp Bowie I, L.P. (*In re* Vill. at Camp Bowie I, L.P.), 710 F.3d 239 (5th Cir. 2013).

[935] *Id.*

[936] Norton Bankr. L. & Prac. 3d § 113:10 (Jan. 2013).

[937] In *Tribune*, the court held that section 1129(a)(10) required an impaired creditor class of each debtor in the corporate organization to vote for the plan instead of a single impaired creditor class across the corporate organization (*i.e.*, among all affiliated debtors) in the joint plan. *In re* Tribune Co., 464 B.R. 126 (Bankr. D. Del. 2011). Prior cases had held that in a joint plan only one accepting class in a joint plan was required. *See, e.g.*, JPMorgan Chase Bank, N.A. v. Charter Commc'ns Operating, LLC (*In re* Charter Commc'ns), 419 B.R. 221 (Bankr. S.D.N.Y. 2009), *aff'd*, 691 F.3d 476 (2d Cir. 2012), *cert. denied*, 133 S. Ct. 2021 (2013).

[938] The Commission reviewed the application of section 1129(a)(10) in single asset real estate cases and agreed with the advisory committee that, on balance, the section was an impediment to confirmation and subject to significant abuse. Both the Commission and the advisory committee supported its elimination in single asset real estate cases.

Ultimately, the Commission determined that the potential delay, cost, gamesmanship, and value destruction attendant to section 1129(a)(10) in all cases significantly outweighed its presumptive gating role. The Commission recommended eliminating section 1129(a)(10) in its entirety from the Bankruptcy Code.

2. Assignment of Voting Rights

Recommended Principles:

- The contractual assignment or waiver of voting rights in favor of senior creditors under an intercreditor, subordination, or similar agreement should not be enforced. Subordinated creditors should retain the right to vote on a plan (or their right to be deemed to have done so under section 1126(g) of the Bankruptcy Code) and to invoke the protections of section 1129(b).
- The contractual assignment of voting rights in favor of an assignee or purchaser of a claim against the estate should be enforced only to the extent of the portion of the claim and economic interest also transferred to the assignee or purchaser. For purposes of this principle, the holder of a claim should be the party entitled to exercise the voting rights assigned or associated with the claim.

a. Assignment of Voting Rights: Background

Creditors may enter into subordination agreements or intercreditor agreements prior to the debtor filing its chapter 11 case. These agreements commonly address the priority of payment as between the creditors from the proceeds of shared collateral. These agreements also may address certain other matters relating to the debtor and the collateral. For example, they may limit the junior creditors' rights to (i) request adequate payment; (ii) offer or participate in post-petition financing for the debtor; (iii) foreclose on the collateral; or (iv) vote on a chapter 11 plan in any chapter 11 case. The last of these provisions may be accomplished through a waiver or assignment of the voting right or underlying claim for voting purposes. Assignments of voting rights also occur between parties outside of the subordination and intercreditor agreement context.

The assignment or waiver of voting rights raises several issues under the Bankruptcy Code. Section 510(a) of the Bankruptcy Code speaks to the enforceability of a pre-petition subordination agreement, providing that "[a] subordination agreement is enforceable in a case under this title to the same extent that such agreement is enforceable under applicable nonbankruptcy law."[939] Courts generally enforce the payment terms of subordination agreements, to the extent that the agreement is otherwise enforceable under state law. Some courts question, however, whether creditors should be permitted to affect or waive specific bankruptcy rights prior to, or in anticipation of, a bankruptcy filing.[940]

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[939] 11 U.S.C. § 510(a).

[940] Sharon L. Levine et al., *If You Assign Your Plan Vote — Mean It*, Law360, July 9, 2013, 5:35 p.m. (discussing recent trends in the enforcement of assignment provisions under subordination agreements). *See also* Edward Rust Morrison, *Rules of Thumb for Intercreditor Agreements*, 2015 Ill. L. Rev. , at *11 (forthcoming 2015) (suggesting that waivers and assignments in an intercreditor agreement should only be enforced if it is "unlikely to affect the

Courts that have declined to enforce assignments or waivers of voting rights in a chapter 11 case focus on the voting provisions of section 1126 and emphasize that the section permits a "holder of a claim . . . under section 502 of this title [to] accept or reject a plan."[941] These courts underscore that the junior creditors are the holders of the claim and that, in turn, only those creditors may exercise the right to vote on the debtor's chapter 11 plan.[942] Courts also question the ability of parties generally to waive rights created by, and only available in a case under, federal bankruptcy laws.[943]

Other courts have enforced voting assignment or waiver provisions in subordination agreements.[944] These courts read section 1126(c) more broadly, noting that it does not prohibit the delegation of rights associated with claims held by a creditor. They also rely on the expressed language of section 510(c) and Bankruptcy Rules 3018 and 9010 and emphasize that the only qualification to enforcement of subordination agreements is that the agreements be enforceable under state law. As one court explained, the Bankruptcy Rules "explicitly permit agents and other representatives to take actions, including voting, on behalf of other parties."[945]

Another issue that arises in the context of voting or claim assignments in chapter 11 cases is whether the assignment decouples the economic and voting rights. This kind of decoupling — sometimes referred to as the "empty creditor problem" — may change the interests or objectives of the party actually exercising the vote. A party with no economic risk or stake in the chapter 11 estate may not be a similarly situated creditor with others in the voting class. Similar concerns exist with a party holding disproportionate voting and economic interests. Although the empty creditor problem is typically discussed in the context of credit default swaps,[946] it also can arise in a simple claim or voting assignment agreement.

b. Assignment of Voting Rights: Recommendations and Findings

The Commission's deliberations on assignments and waivers of voting rights focused largely on two policy considerations: respecting the private contract rights of nondebtor parties and fostering the underlying goals of chapter 11.[947] The

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outcome of the Chapter 11 process (sale versus reorganization, or confirmation of one plan versus another) and primarily to affect the distributions of parties to the agreement.") (draft on file with Commission). *See generally* Tally M. Wiener & Nicholas B. Malito, *On the Nature of the Transferred Bankruptcy Claim*, 12 U. Penn. J. Bus. L. 35 (2009) (discussing claims assignment in bankruptcy generally).

[941] 11 U.S.C. § 1126(a).

[942] *See, e.g., In re* 203 N. LaSalle St. P'ship, 246 B.R. 325 (Bankr. N.D. Ill. 2000).

[943] *In re* Hart Ski Mfg. Co., Inc., 5 B.R. 734 (Bankr. D. Minn. 1980).

[944] *See, e.g.*, Blue Ridge Investors II, LP v. Wachovia Bank, N.A. (*In re* Aerosol Packaging, LLC), 362 B.R. 43, 45–47 (Bankr. N.D. Ga. 2006).

[945] *Id.*

[946] *See, e.g.*, Henry T.C. Hu & Bernard Black, *Debt, Equity and Hybrid Decoupling: Governance and Systemic Risk Implications,* 14 Eur. Fin. Mgmt. 663, 680 (2008) ("Debt decoupling involving the unbundling of the economic rights, contractual control rights, and legal and other rights normally associated with debt, through credit derivatives and securitization. Corporations can have empty and hidden creditors, just as they can have empty and hidden shareholders."); Henry T.C. Hu & Bernard Black, *Equity and Debt Decoupling and Empty Voting II: Importance and Extensions*, 156 U. Pa. L. Rev. 625, 728–35 (2008).

[947] *Written Statement of Daniel Kamensky on behalf of Managed Funds Association: LSTA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Oct. 17, 2012) ("Specifically, lenders and investors must have confidence in their ability to realize upon their investment in the event of a bankruptcy. This includes reliance on

Commissioners observed that a simple response would be to endorse freedom of contract principles among nondebtor parties. The Commission agreed, however, that this response oversimplified the dilemma and was unsatisfactory in several respects. The core issue concerns the impact that private ordering among nondebtor parties may have on the debtor, the estate, and other stakeholders in the chapter 11 case.

The Commissioners discussed the potential impact of voting assignments on the chapter 11 case. They evaluated situations in which senior creditors influence the plan structure or control the vote on the plan through the assignment provision.[948] Such conduct can affect valuations of the debtor's assets, the debtor's postconfirmation operations and capital structure, and the value ultimately available for distributions to other stakeholders.[949] The Commissioners generally were uncomfortable with nondebtor parties being able to change, arguably in very substantive ways, the rights of the debtor and other stakeholders in the chapter 11 case.

The Commissioners also evaluated the classification and voting provisions of the Bankruptcy Code. Many of the Commissioners agreed with courts that have held that section 1126(a) is relevant to the enforceability of voting assignments. Although the section does not address delegation of rights, the reference to "holder of the claim" suggests some nexus between the vote and the holder of the legal right to payment on the claim. They recognized the language of section 510(c), which expressly permits the enforceability of subordination agreements. Many of the Commissioners noted, however, that the provisions included in subordination and intercreditor agreements have significantly expanded beyond the mere ordering of payment among nondebtor parties.[950] The Commission thus considered whether prohibiting voting assignments would significantly affect the payment priority agreed to by the parties under the subordination agreement. Some of the Commissioners argued that allowing junior creditors to vote on the plan may give those creditors bargaining power or control over the plan process, as they would have incentive to increase distributions to their class to provide for repayment of the senior debt and some value for the junior debt. On balance, the Commission found that preserving the agreed-to payment priority was the crucial element of subordination agreements, and that prohibiting assignments or waivers of voting rights would not disturb such a feature.

The Commissioners also identified and discussed many of the same concerns with partial claim assignments and voting assignments outside the subordination agreement context. The Commission determined that requiring economic and voting rights (in

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the enforcement of contracts, applicable state and federal legal rights, including enforcement of lien priority, and the absolute priority rule.").

[948] *See* Morrison, *Rules of Thumb for Intercreditor Agreements*, *supra* note 940, at *7–8 (noting that intercreditor agreements "reduce decisionmaking costs in the event of default, but also give senior lenders power to exploit subordinated creditors and potentially other investors in the firm").

[949] Morrison, *Rules of Thumb for Intercreditor Agreements*, *supra* note 940 (discussing *In re SW Boston Hotel Venture, LLC*, 460 B.R. 38 (Bankr. D. Mass. 2011), in which the secured creditor which was party to an intercreditor agreement ultimately only raised the cost of cramming down a chapter 11 plan that had been accepted by all other classes and which offered full repayment of the secured creditor's claims).

[950] *See generally* Morrison, *Rules of Thumb for Intercreditor Agreements*, *supra* note 940 (noting that some intercreditor agreement provisions (which may provide that certain creditors waive their rights to object to DIP financing or the sale or use of collateral, to seek adequate protection, or to vote on the plan (by assigning their voting rights to senior creditors)) reorder the Bankruptcy Code's bargaining environment).

whole or in part) to be transferred as a package was aligned with the relevant sections of the Bankruptcy Code and mitigated to some extent the empty creditor problem. The Commission also agreed that the holder of the assigned claim should be entitled to exercise any transferred voting rights and may agree to exercise its vote as directed by the beneficial owner (e.g., a bond held in street name is held by a broker, but voted as directed by the account-holder, a holder of a claim that is subject to a participation interest may vote as directed by the participant). The Commissioners recognized that simply requiring transfers of voting and economic rights in the same proportion would not necessarily remedy those situations in which a creditor has hedged its economic losses in the chapter 11 case through a derivative or swap product. Nevertheless, the Commission determined that any potential issues in that context could be best resolved by the court on a case-by-case basis under the new principles addressing designation of votes under section 1126(e).

3. Designation of Votes

Recommended Principles:

- The court should be permitted to designate a party's vote in one or more classes under section 1126(e) of the Bankruptcy Code based on evidence presented at the hearing that such party voted in a manner manifestly adverse to the economic interests of the other creditors in the class or did not act in good faith.

a. Designation of Votes: Background

Section 1126(e) of the Bankruptcy Code allows a court to disqualify a vote on a chapter 11 plan if such vote was not obtained in good faith.[951] Specifically, section 1126(e) provides that, "[o]n request of a party in interest, and after notice and a hearing, the court may designate any entity whose acceptance or rejection of such plan was not in good faith or was not solicited or procured in good faith or in accordance with the provisions of this title."[952] The party seeking designation bears the burden of proof, and this burden has been described as being a "heavy" one.[953]

Courts have disallowed votes under section 1126(e) on the grounds of bad faith when, for example, the claimholder attempts to extract or extort a personal advantage not available to other creditors in its class, the creditor has an "ulterior motive" such as to procure some collateral or competitive advantage that does not relate to its claim, or the motivation behind the vote is not consistent with a creditor's protection of its self-interest as a creditor.[954] "[B]adges of the requisite bad faith include creditor votes designed to (1) assume control of the debtor, (2) put the debtor out of business or otherwise gain a competitive advantage, (3) destroy the debtor out of pure malice or (4)

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[951] 11 U.S.C. § 1126(e).

[952] *Id.*

[953] *See, e.g., In re* Adelphia Commc'ns Corp., 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006) ("The party seeking to have a ballot disallowed has a heavy burden of proof.").

[954] *See, e.g., In re* Dune Deck Owners Corp., 175 B.R. 839 (Bankr. S.D.N.Y. 1995); *In re* Kovalchick, 175 B.R. 863, 875 (Bankr. E.D. Pa. 1994).

obtain benefits available under a private agreement with a third party that depends on the debtor's failure to reorganize."[955] Courts generally agree that self-interest alone is not sufficient to designate a vote under section 1126(e).[956]

b. Designation of Votes: Recommendations and Findings

Some commentators have expressed concerns regarding conflicts of interest that may influence a creditor's conduct, including its vote on a plan, in a chapter 11 case. Such conflicts of interest may include holding claims in multiple classes under the plan, holding interests in competitors of the debtor, having a business agenda that conflicts with the debtor's reorganization, or having nominal economic exposure compared to other creditors in the class because of private agreements or a hedging strategy. The Commission determined that section 1126(e) was the most effective means to address these concerns.

The Commission agreed that holding interests potentially in conflict with the interests of the debtor or other creditors in the voting class should not automatically disqualify a creditor from participating in the case or voting on the chapter 11 plan. Likewise, considering these interests and voting in the creditor's self-interest should not necessarily warrant designation. The Commissioners acknowledged, however, that at some point self-interested conduct by a creditor holding interests adverse to the debtor or other creditors in the class should result in the creditor losing its voting rights in the case.

The Commissioners examined different standards for designating votes and factors relevant to those determinations. For example, the Bankruptcy Code could permit a creditor to vote only in the class representing the holder's predominant economic interest in the case. It could allow the court to designate the holder's vote (including in all classes) if the creditor voted in a manner that was manifestly against the interest of the general holders of claims in that class. Alternatively, it could specifically adopt the "ulterior motive" standard used by some courts under the current version of section 1126(e).

In reviewing these alternatives, the Commissioners started from the basic premise that creditors should be able to vote in their own interests, and that the mere existence of a potential conflict in holdings should not warrant designation. They debated whether section 1126(e) and existing case law adequately address cases in which a creditor votes in a manner intended to delay or disrupt the case, or to disadvantage the treatment of a particular class. The Commission agreed that section 1126(e) arguably allows for remedies in these instances, but many of the Commissioners believed that courts are reluctant to extend the section to these and similar scenarios. These Commissioners argued for a stronger directive in section 1126(e) to guide courts in making these determinations.

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[955] *In re* Adelphia Commc'ns Corp., 359 B.R. 54, 61 (Bankr. S.D.N.Y. 2006).

[956] Figter Ltd. v. Teachers Ins. & Annuity Ass'n of Am. (*In re* Figter Ltd.), 118 F.3d 635, 639 (9th Cir. 1997), *cert. denied*, 522 U.S. 996 (1997).

The Commissioners vetted both the "ulterior motive" standard and one in which courts would focus on whether the conduct or vote was manifestly adverse to other creditors in the class. Some of the Commissioners asserted that the ulterior motive standard was too ambiguous and may not capture cases involving conflicts of interest that cause a creditor to vote adversely to the general interests of creditors in the class — e.g., a creditor who holds a conflict or potential conflict of interest and is the only creditor in the class voting against the plan. Such conduct may not be bad faith or necessarily rise to the level of ulterior motive, but it may objectively be sufficiently harmful that designation is warranted. In this regard, many Commissioners observed significant overlap between the ulterior motive standard and the general bad faith inquiry.[957] On balance, the Commission agreed that section 1126(e) should be amended to permit courts to consider both whether the creditor's vote was "manifestly adverse" to the interests of the general creditors in the class or was cast in bad faith. This hybrid standard would preserve creditor autonomy, but also provide courts with statutory authority to protect the estate and general creditors when a class vote has been infected by a creditor's conflict of interest.

4. Settlements and Compromises in Plan

Recommended Principles:

- In confirming a chapter 11 plan under section 1129 of the Bankruptcy Code, the court should evaluate any settlements and compromises incorporated into the plan under the standard proposed for codification in these principles and grant or deny approval of any such settlements and compromises in the confirmation order under section 1129. This requirement should include any consensual resolution of a material dispute affecting property of the estate, including matters in pending or threatened litigation or regulatory review, but not including the customary resolution of claims or interests asserted against the estate. Accordingly, section 1129(a) should be amended to add a new provision that requires the court to find, based on evidence presented by the debtor or plan proponent at the hearing, that each settlement or compromise incorporated into the plan is reasonable and in the best interests of the estate.
- For the recommended principles on codifying the review standard, see Section V.G, *Standard for Reviewing Settlements and Compromises*.

a. Settlements and Compromises in Plan: Background

A chapter 11 plan in many respects embodies a series of compromises between the debtor and its creditors to resolve the debtor's financial distress and allow the debtor to emerge from bankruptcy. Indeed, the heart of the plan is typically the proposed treatment of creditors' claims, which often compromises creditors' rights, and creditors

[957] For a thoughtful exploration of the grounds for vote designation in chapter 11, *see* Christopher W. Frost, *Bankruptcy Voting and the Designation Power*, 87 Am. Bankr. L.J. 155 (2013) (discussing the policy and use of claims designation under the case law and recommending certain parameters for designation).

accept or reject this proposed compromise by voting on the plan. A chapter 11 plan can also, however, include more substantive settlements or compromises that do not necessarily relate to the claims allowance process, but do have a material role to play in the debtor's emergence from chapter 11. Outside the plan process, these kinds of settlements and compromises would require separate notice and approval by the court, under Bankruptcy Rule 9019, which these principles propose be codified with certain modifications.[958]

Courts employ different approaches to reviewing settlements and compromises incorporated into a chapter 11 plan. Some courts evaluate the settlement or compromise as part of the plan confirmation process under section 1129, without necessarily requiring separate evidence to support the appropriateness of the agreement. These courts in some respects treat creditors' votes on the plan as sufficient for approving or scrutinizing the terms of settlements contained in the plan, including those not involving claims-resolution matters. Other courts require separate motions under Bankruptcy Rule 9019, or at least separate evidence on the proposed settlement in connection with the confirmation hearing. These courts often distinguish settlements involving claims or causes of action held by the estate from those concerning claims against the estate and wrapped up in the claims allowance process. They generally will require some separate consideration of the former, but handle the latter under the section 1129(a) factors.

b. Settlements and Compromises in Plan: Recommendations and Findings

Settlements and compromises in chapter 11 cases may affect a debtor's chapter 11 plan indirectly or directly. A settlement proposed prior to the filing of a chapter 11 plan might indirectly affect the plan by dictating the flow of funds for creditors' recoveries under the plan.[959] Parties may challenge these kinds of preplan settlements as inappropriate sub rosa plans — i.e., disguised plans that are not being subjected to the scrutiny of the plan confirmation process under section 1129.[960] A settlement also may directly affect a chapter 11 plan if it is incorporated into the plan or is a prerequisite to the plan.

The Commission analyzed the interplay between settlements and plans. The Commissioners discussed the facts of the *Iridium* decision and preplan settlements as potential workarounds of the absolute priority rule of section 1129(b).[961] They observed that these issues are largely mitigated if the settlement is considered in connection with

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[958] *See* Section V.G, *Standard for Reviewing Settlements and Compromises*.

[959] *See, e.g.*, United States v. AWECO, Inc. (*In re* AWECO, Inc.), 725 F.2d 293, 298 (5th Cir 1984), *cert. denied*, 469 U.S. 880 (1984) ("[A] bankruptcy court abuses its discretion in approving a [preplan] settlement with a junior creditor unless the court concludes that priority of payment will be respected as to objecting senior creditors"). *Cf.* Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452, 464 (2d Cir. 2007) (rejecting *AWECO* test as "too rigid" and not "accommodate[ing] the dynamic status of some preplan bankruptcy settlements"); *In re World Health Alternatives, Inc*., 344 B.R. 291, 298 (Bankr. D. Del. 2006) (holding that absolute priority rule is not relevant to approval of preplan settlements).

[960] *See* Craig A. Sloane, *The* Sub Rosa *Plan of Reorganization: Side-Stepping Creditor Protections in Chapter 11*, 16 Bankr. Dev. J. 37, 51 (1999).

[961] Motorola, Inc. v. Official Comm. of Unsecured Creditors (*In re* Iridium Operating LLC), 478 F.3d 452 (2d Cir. 2007).

plan confirmation, but they realized that this process forces the issue of whether settlements require separate approval. Some of the Commissioners asserted that the vote on the plan should be sufficient, but others argued that the minority should not be bound by unfavorable compromises. The Commissioners also noted that plan settlements often are not linked to class treatment, so that creditors may not appreciate the terms or import of the settlement in casting their votes.

The Commissioners wrestled with how to identify settlements and compromises that should be subject to separate approval from those integrated into the claims allowance process and addressed by creditors' votes and related provisions in section 1129. The Commission generally agreed that the court should separately approve any consensual resolution of a material dispute affecting property of the estate, including matters in pending or threatened litigation or regulatory review, but not including the customary resolution of claims or interests asserted against the estate. After weighing the advantages and disadvantages of various approaches, the Commission recommended requiring separate consideration of all settlements and compromises included in, or proposed in connection with, a chapter 11 plan under the "reasonable and in the best interests of the estate" standard recommended for settlements and compromises outside of the plan process under these principles. Notably, the Commissioners did not vote to require a separate motion or hearing on plan-related settlements and compromises. Rather, the Commission agreed that section 1129(a) should be amended to require that the court specifically find that all settlements and compromises included in, or related to, the plan are "reasonable and in the best interests of the estate" as part of the confirmation process.

5. Discharge of Claims upon Confirmation

Recommended Principles:

- Except as provided in section 1141(d)(2) and (d)(3) of the Bankruptcy Code and except as otherwise provided in the chapter 11 plan or in the order confirming the plan, after confirmation of a plan, the property dealt with by the plan should be free and clear of all claims and interests of creditors, equity security holders, and of general partners in the debtor, including any interests, liens, or claims that would be removed from the debtor's assets in the context of a section 363x sale under the recommended principles for section 363(f). Section 1141(c) should be amended accordingly. See Section V.B.3, *Transactions Free and Clear of Interests*.

a. Discharge of Claims upon Confirmation: Background

Confirmation of a plan binds the debtor, its creditors, and its interest-holders to the terms of the plan.[962] These parties generally may receive distributions on account of their pre-petition claims and interests only in accordance with the plan, and a business debtor that reorganizes is otherwise discharged from these claims and interests.[963]

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[962] 11 U.S.C. § 1141(a).
[963] *Id.* § 1141(d).

Moreover, under section 1141(c) of the Bankruptcy Code, property dealt with under the plan is free and clear of all such claims and interests.

The language of section 1141(c) is broad, covering "all claims and interests of creditors, equity security holders, and of general partners in the debtor."[964] Yet, some courts have limited its application, particularly in the successor liability context.[965] These courts acknowledge the language of the statute, but also raise due process and notice concerns.[966] The uncertainty surrounding a debtor's ability to transfer property free and clear of all claims and interests can increase transaction costs, generate litigation, and limit the utility of the property in the hands of the reorganized debtor. It also may impede a debtor's ability to reorganize, or may affect its restructuring options in chapter 11.

b. Discharge of Claims upon Confirmation: Recommendations and Findings

Throughout their deliberations, the Commissioners were focused on, among other things, reducing costs in chapter 11, increasing efficiencies, and helping facilitate the restructuring of viable businesses. To that end, the Commission decided to clarify and broaden the kinds of interests, liens, and claims subject to a debtor in possession's ability to sell assets free and clear under section 363(f) of the Bankruptcy Code. In so doing, the Commission recommended a principle that provides, "In the context of a section 363x sale, a trustee should be able to sell assets free and clear of any successor liability claims (including tort claims) other than those specifically excluded from free and clear sales by these principles."[967] The Commission determined that a similar provision should govern property dealt with under a plan.

The Commissioners discussed the relevant policy considerations, and they believed that a chapter 11 plan should provide protection from claims as broad as that recommended by the Commission to be available in a section 363x sale. In addition, some Commissioners voiced concerns that treating these two situations differently could encourage a sale of the debtor's assets even when reorganization was feasible or a better alternative for many of the debtor's stakeholders. Although the Commission recommended principles to govern the sale of substantially all of a debtor's assets under section 363x, the Commission agreed that such sales should not provide better or meaningfully different treatment for parties than the plan process. Accordingly, if a debtor in possession[968] could sell assets free and clear of a particular claim under the

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[964] *Id.* § 1141(c). *See also* GEORGE M. TREISTER ET AL., FUNDAMENTALS OF BANKRUPTCY 425 (7th ed. 2010) ("Congress in Chapter 11 intended that the confirmed plan would . . . discharg[e] all obligations to creditors, whether or not the creditors participated in the reorganization process.").

[965] For a thorough examination of successor liability law, *see* George W. Kuney, *A Taxonomy and Evaluation of Successor Liability*, 6 Fla. St. Bus. L. Rev. 9 (2007).

[966] *See, e.g.*, Kewanee Boiler Corp. v. Smith (*In re* Kewanee Boiler Corp.), 198 B.R. 519, 540 (Bankr. N.D. Ill. 1996) (explaining that "enjoining [the tort victim's] efforts to liquidate his claim against the reorganized debtor and forcing him to partake in [the] bankruptcy would be an inadmissible deprivation of his property interest in that claim, wholly without prior due process notice or bankruptcy notice").

[967] *See* Section V.B.3, *Transactions Free and Clear of Interests*.

[968] As previously noted, references to the trustee are intended to include the debtor in possession as applicable under section 1107 of the Bankruptcy Code, and implications for debtors in possession also apply to any chapter 11 trustee appointed in the case. *See supra* note 76 and accompanying text. *See generally* Section IV.A.1, *The Debtor in Possession Model*.

recommended principles for section 363(f), a debtor or plan proponent also should be able to achieve a similar result under sections 1129 and 1141.

G. Orders Resolving Chapter 11 Case (Exit Orders)

Recommended Principles:

- The Bankruptcy Code should be amended to clarify that a chapter 11 case can be resolved only in the following three ways: (i) confirmation of a plan under section 1129; (ii) conversion of the case under section 1112; and (iii) dismissal of the case subject to section 349.

1. Orders Resolving Chapter 11 Case (Exit Orders): Background

In general, a debtor exits chapter 11 through a confirmation order, a dismissal order, or a conversion order. Section 1129 governs the entry of an order confirming a chapter 11 plan.[969] Section 1112 generally provides that "on request of a party in interest, and after notice and a hearing, the court shall convert a case under this chapter to a case under chapter 7 or to dismiss a case under this chapter, whichever is in the best interests of creditors and the estate, for cause."[970] Section 305 permits a court to dismiss or suspend a case under the Bankruptcy Code if "the interests of creditors and the debtor would be better served by such dismissal or suspension."[971] Moreover, section 349 addresses the effect of a dismissal order and provides, among other things, that such an order reinstates certain liens and actions, vacates certain orders, and revests property in its pre-petition owner.[972]

The Bankruptcy Code's alternatives for ending a chapter 11 case are fairly straightforward. Nevertheless, courts have been confronting an exit strategy for chapter 11 debtors that does not necessarily fall within the traditional exit alternatives, commonly called a structured dismissal.[973] A "structured dismissal" is a hybrid dismissal and confirmation order in that it typically dismisses the case while, among other things, approving certain distributions to creditors, granting certain third party-releases, enjoining certain conduct by creditors, and not necessarily vacating orders or unwinding transactions undertaken during the case. These additional provisions — often deemed "bells and whistles" — are usually the result of a negotiated and detailed settlement arrangement between the debtor and key stakeholders in the case.

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[969] 11 U.S.C. § 1129.
[970] *Id.* § 1112(b).
[971] *Id.* § 305(a).
[972] *Id.* § 349.
[973] Although structured dismissals appear to be increasingly common, some cases suggest that structured dismissals are not a recent development. *See In re* Buffet Partners, L.P., 2014 WL 3735804 (Bankr. N.D. Tex. July 28, 2014) ("On a smaller scale, structured dismissals occur regularly in this and other bankruptcy courts. Often the parties enter the case on the eve of foreclosure, work out their differences through a sale or giveback of property, and the parties enter an agreement submitted to this court for approval that results in the dismissal of the case."); *In re* Aerospace & Indus. Mfg., Inc., 2008 WL 2705071 (Bankr. N.D. Tex. July 7, 2008) (dismissing case pursuant to a settlement agreement because dismissal will result "in a more favorable return to unsecured creditors . . . who otherwise risk receiving nothing in the case").

Structured dismissals are subject to some controversy as a result of these bells and whistles. Opponents of structured dismissals argue that the Bankruptcy Code either does not authorize or expressly prohibits some of the provisions included in these dismissal orders.[974] Proponents of structured dismissals, on the other hand, argue that the Bankruptcy Code does authorize the practice and note how practical and efficient structured dismissals can be in certain cases.

Some of the common features present in structured dismissal cases are noted below:

- Substantially all of the debtor's assets have been sold pursuant to a section 363 sale.
- The debtor's estate is essentially reduced to cash to be distributed.
- The secured creditors are undersecured and there are insufficient funds to pay the administrative claims associated with the case (the case is administratively insolvent).
- A detailed settlement agreement (or similar) that disposes of significant issues in the case has been approved by the court and may have been consummated.
- As a result of the settlement agreement (or similar), the proceeds of the sale of the debtor are transferred from the estate to the undersecured lender.
- There is an alternative claims-allowance process.
- There are third-party release provisions.
- A portion of the sale proceeds have been carved out to create a "gift" trust to benefit lower priority creditors, proceeds to which they would likely not be entitled in a chapter 11 plan.
- The court retains jurisdiction over the case after dismissal and all prior court orders survive the dismissal.

The debate regarding the authority of a court to issue an order approving a structured dismissal is grounded in the Bankruptcy Code. Parties on both sides of the debate agree that (i) the court is authorized to issue a "plain vanilla" case dismissal order for cause when in the best interests of creditors and the estate, and (ii) the Bankruptcy Code is silent regarding what a dismissal order may or may not contain. Proponents of structured dismissals focus on sections 1112(b) and 305(a) of the Bankruptcy Code as grounds for approving such dismissals. Opponents focus on the purpose of section 349[975] and the general principle that section 305(a) is considered an

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[974] *See* 11 U.S.C. § 349(b).

[975] *See, e.g.*, H.R. Rep. No. 95-595 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5787, 6294 ("The basic purpose of [section 349] is to undo the bankruptcy case as far as practicable, and to restore all property rights to the position in which they were found at the commencement of the case."). *See also* Armel Laminates, Inc. v. Lomas & Nettleton Co. (*In re* Income Prop. Builders, Inc.), 699 F.2d 963, 965 (9th Cir. 1982) ("11 U.S.C. § 349, treating the effects of a bankruptcy, obviously contemplates that on dismissal a bankrupt is reinvested with the estate, subject to all encumbrances which existed prior to the bankruptcy. After an order of dismissal, the debtor's debts and property are subject to the general laws, unaffected by bankruptcy concepts. After dismissal a debtor may file another petition for bankruptcy unless the initial petition was dismissed with prejudice."); Citizens First Nat'l Bank of Princeton v. Rumbold & Kuhn, Inc. (*In re* Newton), 64 B.R. 790, 793 (Bankr. C.D. Ill. 1986) ("[T]o the extent possible a dismissal of a petition reverses what has transpired during a bankruptcy."); *In re* Safren, 65 B.R. 566, 571 (Bankr. C.D. Cal. 1986) ("The objective of section 349(b) is to restore all property rights, insofar as is practicable, to their positions when the case was filed.").

extraordinary remedy because a court's order under that section is not subject to review on appeal.[976] Other Code sections and legislative history also are cited on both sides of the debate.

2. Orders Resolving Chapter 11 Case (Exit Orders): Recommendations and Findings

Anecdotal evidence suggests that the increasing use of structured dismissals is linked directly to the rise in sales of all or substantially of a debtor's assets under section 363 and outside of the plan process. Parties may request a structured dismissal because of the actual or perceived costs and delays associated with the plan-confirmation process or a conversion to chapter 7 of the Bankruptcy Code. Parties also may resist a conversion because of the automatic appointment of a trustee and the subordination of unpaid administrative claims in the chapter 11 case to the administrative claims incurred by the chapter 7 trustee.

The Commissioners acknowledged that courts are approving structured dismissals to try to facilitate efficient case resolutions. Some of the Commissioners supported the use of structured dismissals when no other alternative is available to monetize the debtor's assets for the benefit of at least some creditors. Other Commissioners observed that there are always alternatives — e.g., a sale followed by a clean section 1112/349 dismissal order, a sale followed by conversion to chapter 7, a sale in chapter 7, a sale after a clean dismissal under state law. These Commissioners noted that a lack of alternatives was not the issue; rather, it really was driven by the desire of the purchaser, debtor, or other key stakeholder to sell the assets free and clear under section 363(b) and (f) of the Bankruptcy Code quickly, plus to get some of the benefits of a confirmation order without complying with the disclosure and soliciting provisions of the confirmation process.

The Commissioners debated the advantages and disadvantages of structured dismissals. The Commissioners generally believed that debtors should be able to sell all or substantially all of their assets under section 363(b) when that is the best and most efficient way to maximize value and potentially rehabilitate the business. They did not, however, endorse a process that short-circuits or completely eliminates creditor protections under the Bankruptcy Code. The Commissioners discussed certain components of structured dismissals that were particularly troubling in this respect, including provisions that violate the absolute priority rule,[977] grant third-party releases,[978] or deviate from the traditional claims-allowance process.[979] As explained by the court in *LCI Holding Co.*:

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[976] *See, e.g., In re* Monitor Single Lift I Ltd., 381 B.R. 455, 463 (Bankr. S.D.N.Y. 2008) ("Granting an abstention motion pursuant to § 305(a)(1) requires more than a simple balancing of harm to the debtor and its creditors; rather, the interests of both the debtor and its creditors must be served by granting the requested relief.").

[977] *See, e.g., In re* Jevic Holding Corp., No. 14-01465 (3d Cir. Aug. 14, 2014) [Docket. No. 45] (citing Begier v. I.R.S., 496 U.S. 53, 58 (1990)).

[978] *In re* Jevic Transp. Corp., No. 13-00104 (SLR) (D. Del. Jan. 24, 2014) [Docket No. 22]. Indeed, a structured dismissal may provide a broader third-party release than otherwise would be permissible in the chapter 11 case. For example, the release provision in *TLG Liquidation* is particularly notable:

> The Debtors, for themselves and their estates, and the Committee, for itself and its members, representatives, agents, professionals, successor and assigns . . . release and forever discharge any and all Claims and Defenses against the Agent, each of the Lenders

> The motion [requesting approval of a sale and dismissal order] attempts to restructure the rights of existing creditors and equity, without affording parties in interest the protections of a plan, disclosure statement and the confirmation solicitation process. . . . Were the Term Sheet presented as a plan, the Court would be required to approve a disclosure statement to be used to solicit votes from the impaired creditor classes. The Term Sheet raises multiple issues that a disclosure statement would address. These issues include claim resolution procedures, resolution of fee claims[, etc.]. . . . A disclosure statement would also have to address facts not disclosed in the motion, including but not limited to a budget, a liquidation analysis, and the existence of any additional assets.[980]

The Commissioners first considered whether provisions could be drafted that would facilitate some of the objectives of a structured dismissal, but that would not impede the rights of, and key protections for, creditors in the case. As the Commissioners started to carve out problematic provisions from an "acceptable" structured dismissal, they recognized that it likely was an unworkable solution. They bolstered this conclusion by reviewing the recommended principles for section 363x sales. Under these recommended principles, a sale of all or substantially all of a debtor's assets will incorporate appropriate creditor protections from the confirmation process. If these protections are implemented, the court may approve the sale, and its order may include (i) a release or discharge to affect claims protection for the purchaser and (ii) certain specified distributions to priority creditors. The Commissioners believed that the recommended principles for section 363x sales should render the use of structured dismissals unnecessary.

Accordingly, the Commission recommended strict compliance with the Bankruptcy Code in terms of orders ending the chapter 11 case. Specifically, the Commission agreed that a court should be permitted to confirm a plan under section 1129, convert a case under section 1112, or dismiss a case provided that the requested dismissal and the dismissal order satisfy the applicable provisions of, and do not permit the parties to work around, the Bankruptcy Code.

> and their respective shareholders, partners, members, officers, directors, managing members, employees, representatives, agents, professionals, successors and assigns, from the beginning of time through the date the Approval Order becomes a final and nonappealable order.

In re TLG Liquidation Corp., No. 10-10206 (MFW) (Bankr. D. Del. Apr. 30, 2010) [Docket No. 275].

[979] For example, in some cases, claims are allowed in the amounts submitted in the dismissal motion unless there is an objection. *See In re* GI Joe Holding Corp., No. 09-10713 (KG) (Bankr. D. Del. Feb. 23, 2011) [Docket No. 746]; *In re* Wickes Holdings LLC, No. 08-10212 (Bankr. D. Del. May 12, 2009) [Docket No. 1418].

[980] *In re* LCI Holding Co., No. 12-13319 (KG) (Bankr. D. Del. May 21, 2013) [Docket No. 773].

VII. PROPOSED RECOMMENDATIONS: SMALL AND MEDIUM-SIZED ENTERPRISE (SME) CASES

Most business bankruptcy cases filed in the United States involve small and middle-market enterprises. These businesses include family owned businesses, entrepreneurial ventures, and startup companies. They form the backbone of the American economy. As explained in one survey, "[a]ccording to the U.S. Economic Census, companies with 50 to 5,000 employees account for more employment than those with over 5,000."[981] This survey also noted that "in terms of output, the sheer number of mid-market firms accounts for the fact that, in aggregate, their revenues surpass those of the top 100 U.S. companies by capitalization and are equivalent to roughly 40 percent of the U.S. GDP."[982]

Nevertheless, small and middle-market enterprises are prone to preliminary setbacks and initial failures, and they can be among the hardest hit in economic downturns.[983] The chart [Eds. note – not pictured here] from the Bureau of Labor Statistics generally indicates that among new businesses, approximately 50 percent of those businesses fail within the first five years of operation and approximately 70 percent fail before their tenth anniversary.[984]

In addition, established small and middle-market companies can experience failed acquisitions, underperforming product lines, overcapitalization, and other factors that contribute to financial distress and threaten their survival. Yet many commentators and practitioners assert that the Bankruptcy Code no longer works to help rehabilitate these

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[981] Deloitte Development LLC, *Mid-Market Perspectives: America's Economic Engine — Competing in Uncertain Times* 4 (2011), *available at* http://www.deloitte.com/assets/DcomUnitedStates/Local%20Assets/Documents/us_dges_competing_in_uncertain_times_09202011.pdf.

[982] *Id. See also Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1, 4 (Nov. 15, 2012) ("The importance of facilitating reorganizations, especially for SMEs, cannot be overstated. Start-up and small businesses create and provide a significant portion of jobs in the United States . . . . For example, in 2010, 505,473 new businesses were started. These businesses employed over 2,456,000 people."), *available at* Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012), *available at* Commission website, *supra* note 55.

[983] Donald R. Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, 23 Cap. U. L. Rev. 413, 426–27 (1994) ("Larger businesses also tend to have more operational flexibility, and sometimes may weather economic slow-downs by shifting from one product line to another, or from one geographical area to another. In contrast, small businesses are less likely to have cash reserves, and they are generally undiversified in their products and customer base. Furthermore, small businesses are often in industries characterized by intense price competition. During inflationary times, they may not have the luxury of raising prices in order to compensate for rising operating expenses. Meanwhile, regulatory burdens and tax increases hit small business the hardest, depleting severely limited working capital.") (citations omitted); *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 2 (Nov. 15, 2012), *available at* Commission website, *supra* note 55 ("[A]lthough large U.S. corporations play an important role in the U.S. economy, CFA believes that an even greater role is played by small and medium-sized enterprises ("SMEs"). Commercial finance (in both its asset-based lending and cash-flow lending forms) has traditionally been, and continues to be, the backbone of financing for SMEs in the United States. Although many of the current suggestions for amending the Code (including some from Commissioners) are designed to address perceived problems arising in the chapter 11 cases of large corporations, these concerns are not necessarily applicable to chapter 11s of SMEs (which currently comprise the greatest number of chapter 11 cases).").

[984] *See* Bureau of Labor Statistics, *Business Development Dynamics, Entrepreneurship and the U.S. Economy*, *available at* http://www. bls.gov/bdm/entrepreneurship/bdm_chart3.htm.

companies.[985] As one witness testified, "Chapter 11 is now viewed as too slow and too costly for the majority of middle-market companies to do anything other than sell its going concern assets in a 363 sale or to simply liquidate the company . . . [usually] almost exclusively for the sole benefit of the secured lender."[986]

The Commission heeded the concerns raised by several witnesses regarding the plight of small and middle-market enterprises in financial distress.[987] These perspectives aligned with the results of an empirical survey conducted by Professor Dalié Jiménez, as illustrated in the following chart:[988]

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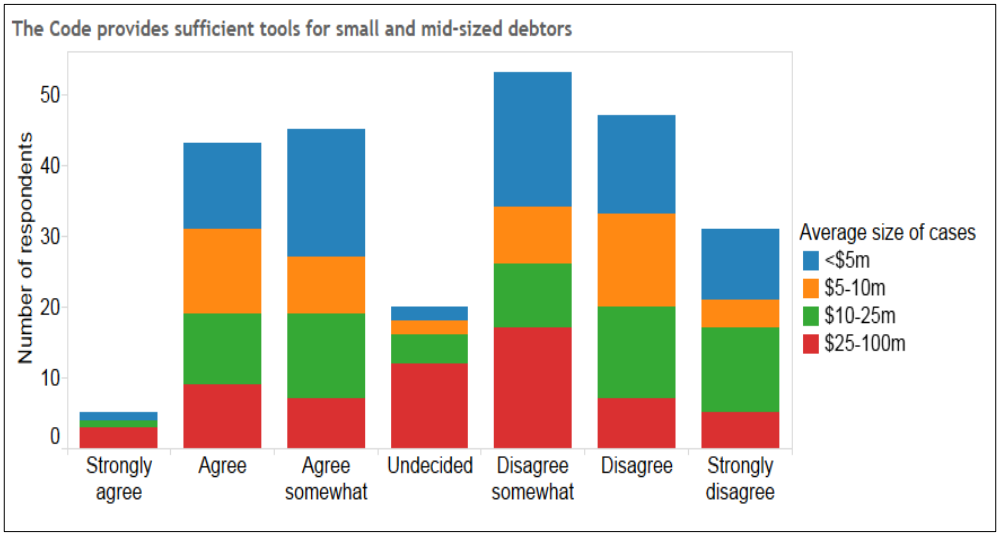
[985] *See, e.g.*, *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) ("[C]omplexity, time, and costs of the Chapter 11 process impose obstacles that small and middle-market businesses often cannot overcome."), *available at* Commission website, *supra* note 55. *See also Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), *available at* Commission website, *supra* note 55; *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013) ("It is widely understood and agreed in the insolvency community that Chapter 11 is no longer a cost effective process in the middle market . . . . Chapter 11 is now viewed as too slow and too costly for the majority of middle-market companies to do anything other than sell its going concern assets in a 363 sale or to simply liquidate the company . . . [usually] almost exclusively for the sole benefit of the secured lender."), *available at* Commission website, *supra* note 55.

[986] *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Apr. 19, 2013), *available at* Commission website, *supra* note 55. *See also Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

[987] For example, one witness noted that data from the Census Bureau and the Bureau of Labor Statistics indicate that entrepreneurship has decreased since 1994. The witness suggested that changes in the Bankruptcy Code were partially to blame. *Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 8 & n.1 (Nov. 3, 2012), *available at* Commission website, *supra* note 55. *See also* Michelle J. White, *Bankruptcy and Small Business*, Reg. Mag. 18, Summer 2001 (arguing that the BAPCPA reforms would make entrepreneurs less likely to start businesses), *available at* http://object.cato.org/sites/cato.org/files/serials/files/regulation/2001/7/white.pdf.

[988] *See* Dalié Jiménez, *ABI Chapter 11 Survey Results*, Am. Bankr. Inst. J., July 2014, at 11 (containing the results of Professor Jiménez's entire survey). Professor Jiménez found that "[a]bout 15% of the then 2,158 members of the Business Restructuring Committee responded to the survey, for a total of 322 responses. While the response rate could have been higher, this is typical of online surveys and in line with previous ABI surveys. Nonetheless, these findings must be interpreted with a grain of caution." *Id. See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).



The Commissioners solicited the testimony and input of practitioners and judges familiar with small and middle-market cases and thoroughly studied the issues identified as barriers to effective reorganizations in this space. They also, with the assistance of the Reporter and a report from the governance advisory committee, reviewed the literature and empirical evidence on small business cases in chapter 11. The Commission strongly believed that the following set of principles for small and middle-market enterprises can have a significant and positive influence on the ability of these companies to effectively reorganize in and outside of chapter 11.

A. Definition of SME

Recommended Principles:

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

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

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

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

- The court sua sponte, the U.S. Trustee, or a party in interest should be able to object to the debtor's indication in the petition that it satisfies subsections (i) and (ii) above and qualifies as an SME, but only on the grounds that the debtor does not in fact meet the definition of SME under the Bankruptcy Code. Such

objection should be filed on or before 14 days after notice of the debtor's indication in the petition that it qualifies as an SME, and it should be heard on an expedited basis.

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

1. Definition of SME: Background

The utility of chapter 11 for smaller companies is not a new concern. Shortly after the enactment of the Bankruptcy Code, commentators raised concerns regarding the ability of smaller debtors to confirm chapter 11 plans.[989] Congress attempted to address these concerns in 1994 by introducing a small business election provision in chapter 11.[990] The 1994 amendments defined "small business" as "a person engaged in commercial or business activities (but does not include a person whose primary activity is the business of owning or operating real property and activities incidental thereto) whose aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition do not exceed $2,000,000."[991] A person qualifying as a small business could elect themselves into a fast track chapter 11 plan process that allowed the court, among other things, to conditionally approve the debtor's disclosure statement and to combine the hearing on the adequacy of the disclosure statement and the approval of the plan.[992] The amendments also allowed the court to order that a committee of unsecured creditors not be appointed in a small business case.[993]

Congress further amended the small business provisions of chapter 11 in 2005 in response, at least in part, to the ongoing issues with small business cases identified by

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[989] *See* LoPucki, *The Trouble with Chapter 11*, *supra* note 82, at 749–51 (1993) (discussing how the initial identical treatment of large and small business cases evolved).

[990] *See id.* at 751–52 (describing how the procedures developed by Judge Small resulted in the small business reorganization pilot program in 1992 and ultimately the legislative changes to the Bankruptcy Code in 1994); James B. Haines, Jr. & Phillip J. Hendel, *No Easy Answers: Small Business Bankruptcies After BAPCPA*, 47 B.C.L. Rev. 71, 73 (2005).

[991] 11 U.S.C. § 101(51C) (1994).

[992] *Id.* §§ 1121, 1125 (1994).

[993] *Id.* § 1102(a) (1994).

the National Bankruptcy Review Commission's (the "NBRC") study and report (the "NRBC report").[994] The NBRC report concluded that small business debtors fell into two categories: (i) a small number with a reasonable likelihood of reorganizing and succeeding as a going concern; and (ii) a larger number with no reasonable prospect of rehabilitation.[995] The NBRC suggested that reform focus on increasing the likelihood of success for those debtors who might succeed and reducing the amount of time a likely-to-fail debtor spends in chapter 11.[996]

The NBRC report concentrated to some extent on those small business debtors that were unlikely to rehabilitate.[997] The NRBC report indicated that small businesses benefited from the protections of chapter 11 — the automatic stay, retention of control of the business, ability to delay payments to creditors, and ability to delay formulating a chapter 11 plan — while administrative costs increased, even though there was no realistic prospect of rehabilitation.[998] Chapter 11 arguably only prolonged these debtors' imminent demise and reduced recoveries for creditors.[999] The NBRC proposed reforms to address these likely-to-fail debtors and to try to reduce overall cost and delay for small business debtors.[1000] These changes included establishing presumptive plan filing and plan confirmation deadlines,[1001] additional post-petition documentation requirements, more reporting, and changes to the burden of proof for small business debtors.[1002] In adopting these provisions, Congress also removed the elective nature of the small business provisions and amended the definition of the "small business debtor" that would be subject to these mandatory provisions.[1003]

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[994] NBRC Report, *supra* note 37. *See also* Thomas E. Carlson & Jennifer Frasier Hayes, *The Small Business Provisions of the 2005 Bankruptcy Amendments*, 79 Am. Bankr. L.J. 645 (2005).

[995] NBRC Report, *supra* note 37, at 609.

[996] *Id.*

[997] *See* H. Rep. No. 109-31, Part 1, at 3 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89 (noting that the legislation includes "several significant provisions intended to heighten administrative scrutiny and judicial oversight of small business cases, which often are the least likely to reorganize successfully").

[998] *See* Edward R. Morrison, *Bankruptcy Decision Making: An Empirical Study of Continuation Bias in Small-Business Bankruptcies*, 50 J. L. & Econ. 381, 382–83 (2007) (citing others who believe that chapter 11 allows firms that should be liquidated to linger on indefinitely).

[999] NBRC Report, *supra* note 37, at 612–13 ("The length of time a business remains in Chapter 11 is critically important. 'During that time, the business is at risk because management incentives are inappropriate, professional fees build up at a rapid rate, and business uncertainties increase.' Furthermore, unsecured creditors lose the time value of money while they wait to collect their debt during the pendency of the case. The longer they await distribution, the greater is their loss.") (citing Lynn M. LoPucki, *The Debtor in Full Control — Systems Failure Under Chapter 11 of the Bankruptcy Code? (First Installment)*, 57 Am. Bankr. L.J. 99, 100 (1983); Philip J. Hendel, *Position Paper to the National Bankruptcy Review Commission Proposing Expanded Use of Chapter 13 to Include Closely Held Corporations and Other Business Entities* (Dec. 17, 1996).

[1000] *See* H. Rep. No. 109-31, Part 1, at 19 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 105 (stating that the "variety of time frames and enforcement mechanisms [were] designed to weed out small business debtors who are not likely to reorganize"); NBRC Report, *supra* note 37, at 609 (stating that for the large group of debtors with "no reasonable prospect for rehabilitation . . . the primary goal is to reduce the amount of time they consume in Chapter 11").

[1001] NBRC Report, *supra* note 37, at 615.

[1002] *Id.* at 618–25.

[1003] *Id.* at 618. *See also* Haines & Hendel, *supra* note 990. Section 101(51D) defines "small business debtor" as follows:

> (A) subject to subparagraph (B), means a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under this title and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated

At that time, some commentators testified before the NBRC that the reduced deadlines would provide too little time and shifting the burden of proof would be too onerous, and that these provisions would deprive debtors of a fair opportunity to reorganize in chapter 11.[1004] Others commented that the system was working relatively well and that bankruptcy judges were doing a good job of filtering failing firms from viable ones.[1005] Unfortunately, time has proven those commentators right to some extent. Witnesses before the Commission generally testified that chapter 11 is not working for small and middle-market debtors, and several of these witnesses suggested that certain of the deadlines imposed by the BAPCPA amendments were particularly challenging and counterproductive for small business debtors.[1006]

Moreover, several witnesses and commentators have observed an increasing use of state and federal law insolvency alternatives by small and middle-market enterprises in

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> secured and unsecured debts as of the date of the filing of the petition or the date of the order for relief in an amount not more than $2,000,000 (excluding debts owed to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and
>
> (B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than $2,000,000 (excluding debt owed to 1 or more affiliates or insiders).

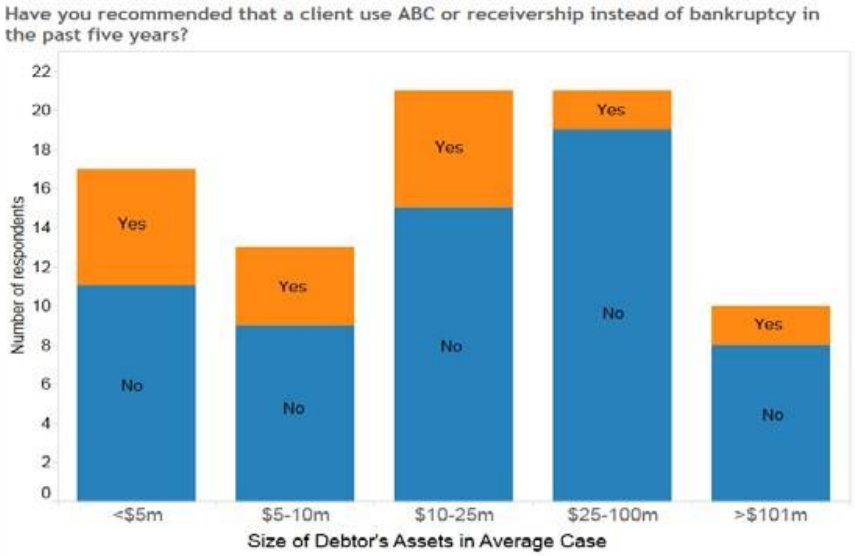
11 U.S.C. § 101(51D). Several commentators have criticized the definition as being too complex and difficult to apply in many cases. *See, e.g.*, Anne Lawton, *An Argument for Simplifying the Codes "Small Business Debtor" Definition*, 21 Am. Bankr. Inst. L. Rev. 55 (2013). For example, the types of assets at issue may give rise to questions concerning whether the debtor is a small business case or a single asset real estate case. *Id.* at 72–76. Likewise, determining whether liabilities are noncontingent and liquidated may not be a straightforward calculation. *Id.* at 83–88.

[1004] NBRC Report, *supra* note 37, at 616.

[1005] *See* Douglas G. Baird, *Remembering Pine Gate*, 38 J. Marshall L. Rev. 5, 15 & n. 35 (2004) ("The benchmark by which to judge the bankruptcy system in small cases is not the sheer number of businesses saved, but their ability to sort effectively and quickly. Most important is identifying those cases in which the debtor is only playing for time. The evidence suggests that bankruptcy judges can do this job exceedingly well. Indeed, the data are consistent with the conjecture that bankruptcy judges perform this job as well as a market actor subject to the same constraints.") (citing Morrison, *Bankruptcy Decisionmaking*, *supra* note 998). Morrison conducted an empirical study of nearly all the chapter 11 cases filed by corporations outside the real estate sector who filed in the Northern District of Illinois in 1998. He found that the bankruptcy process identified over 70 percent of nonviable firms within six months and 44 percent were identified within three months; only 8.5 percent of nonviable firms had not been identified by one year. *See* Morrison, *Bankruptcy Decisionmaking*, *supra* note 998, at 14. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies). *See also* Elizabeth Warren & Jay Lawrence Westbrook, *The Success of Chapter 11: A Challenge to the Critics*, 107 Mich. L. Rev. 603 (2009) (finding that the pre-BAPCPA system was successfully screening cases).

[1006] *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013) (stating it is nearly impossible to do anything but have a section 363 sale in the middle market), *available at* Commission website, *supra* note 55. "Middle-market companies just do not have either the management or financial resources to attempt to remain in Chapter 11 long enough to reorganize." *Id. See also Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11* (Nov. 15, 2012) (requesting that the BAPCPA plan deadlines be repealed because "the secured lender is concerned about these deadlines and consequently takes action (or requires the debtors to take action) months before these deadlines occur in order to reduce its credit risk — all of which hurts the flow of funds to the debtor and ultimately inures to the detriment of the reorganization process"), *available at* Commission website, *supra* note 55.

lieu of a chapter 11 filing.[1007] These alternatives include state and federal receiverships and assignments for the benefit of creditors ("ABCs") under state law.[1008] This testimony again generally aligned with the results of the empirical survey conducted by Professor Jiménez, as illustrated by the following chart:[1009]



In a receivership, a person — the receiver — is appointed by a court to take property into custody and preserve it; receiverships are often used as a method for liquidating entire businesses.[1010] Commentators argue that receiverships are attractive for several reasons: Receivers may be granted powers that are broader and more flexible

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[1007] *Written Statement of Daniel Dooley: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Apr. 19, 2013) (stating that the use of federal receiverships is growing in the insolvency community but noting that the federal statute on receiverships does not have well-developed processes and rules), *available at* Commission website, *supra* note 55; *Written Statement of John Haggerty: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) (noting that there has been an increase in the use of out-of-court alternatives for turnarounds, restructurings, sales and liquidations, particularly for smaller businesses), *available at* Commission website, *supra* note 55.

[1008] *See id. See also* Edward R. Morrison, *Bargaining Around Bankruptcy: Small Business Workouts and State Law*, 38 J. Legal Stud. 255, 256 (2009) (stating that in 2003, about 540,000 small businesses closed their doors but only 34,000 filed for bankruptcy and that the "vast majority of small businesses resolve distress under state law"); Edward R. Morrison, *Bankruptcy's Rarity: Small Business Workouts in the United States*, 5 Euro. Co & Fin. L. Rev. 172 (2008) (asserting that federal bankruptcy filings account for only three to four percent of all business closures). *Accord* Edward I. Altman et al., *The Value of Non-Financial Information in SME Risk Management*, J. Credit Risk, Summer 2010, at 7 (distinguishing between failure and closure and citing a study that indicated about 33 percent of new businesses closed because they were unsuccessful) (citation omitted), *available at* http://people.stern.nyu.edu/ealtman/Altman-Sabbato-Wilson-JCR_2010.

[1009] *See* Jiménez, *supra* note 988, at 79. Professor Jiménez found that "[m]ore than a quarter (26 percent) had been involved in an equity receivership in the past five years. Most of these (69 percent) noted that their participation in federal equity receivership cases had increased in the last five years, 27 percent thought it was about the same, and only 5 percent responded that it had decreased." *Id.*

[1010] Business Organizations with Tax Planning § 155.01.

than those under the Bankruptcy Code;[1011] nonbankruptcy courts are able to use summary remedies to allow, disallow, and subordinate the claims of creditors, which promotes judicial efficiency and reduces litigation costs;[1012] lack of certainty in chapter 11 due to divergent case law;[1013] and lastly, receiverships are less time-consuming and costly than chapter 11 to liquidate property.[1014] Receivership has traditionally been considered an extraordinary remedy[1015] and may only be available in specific circumstances,[1016] particularly when statutory authority for the receivership is lacking.[1017]

An ABC involves a consensual transfer of assets by the debtor to an assignee who holds them in trust for the benefit of creditors.[1018] ABCs are a function of state law, with many states requiring court supervision of the ABC and with other states not requiring such oversight.[1019] The law governing ABCs, like the law covering receiverships, is often a mixture of common law and statutory law and varies significantly by state.[1020]

These state law alternatives are subpar remedies in many circumstances and present their own problems. For example, some debate a receiver's ability to sell property free and clear of liens without the consent of all lienholders.[1021] Case law is inconsistent as

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[1011] M. Colette Gibbons et al., *Lien on Me*, Ohio Lawyer, May/June 2011,at 18; M. Colette Gibbons & Jason Grimes, *A Model Statute for Free-and-Clear Sales by Equity Receivers*, Am. Bankr. Inst. J., Mar. 2009, at 3. *See also* 16 Charles Alan Wright & Arthur R. Miller, Federal Practice and Procedures § 3925 (3d ed.) ("A receivership can drastically curtail existing property rights . . . . ."); SEC v. Black, 163 F.3d 188 (3d Cir. 1998) ("[W]here there is a receiver with equitable power in a proceeding before it, the District Court has wide discretion as to how to proceed."); SEC v. Hardy, 803 F.2d 1034 (9th Cir. 1986) ("[A] district court's power to supervise an equity receivership and to determine the appropriate action to be taken in the administration of the receivership is extremely broad."); SEC v. Safety Fin. Serv., Inc., 674 F.2d 368 (5th Cir. 1982) ("It is a recognized principle of law that the district court has broad powers and wide discretion to determine the appropriate relief in an equity receivership.").

[1012] Gibbons & Grimes, *supra* note 1011, at 3 (citing SEC v. Basic Energy & Affiliated Res. Inc., 273 F.3d 657, 668 (6th Cir. 2001)). *See also* SEC v. Elliott, 953 F.2d 1560 (11th Cir. 1992), *rev'd in part on other grounds sub nom.* SEC v. Elliott, 998 F.2d 922 (11th 1993) (*per curiam*).

[1013] Gibbons & Grimes, *supra* note 1011, at 3 (discussing the decision in *Clear Channel Outdoor, Inc. v. Knupfer*, 391 B.R. 25 (B.A.P. 9th Cir. 2008), in which the court held that the sale of the debtor's assets was not free and clear of all liens when the price paid did not exceed the aggregate value of all liens on the property, in violation of section 363(f)(3)).

[1014] *See* Business Organizations with Tax Planning § 155.01 ("Cost is often the major factor that makes a receivership attractive when compared to a federal bankruptcy proceeding").

[1015] *Id.* (citing *Solis v. Matheson*, 563 F.3d 425, 437 (9th Cir. 2009), in which the court held that a receivership is an "extraordinary remedy" requiring "clear necessity" and should be "employed with the utmost caution"); *Peterson v. Islamic Republic of Iran*, 563 F. Supp. 2d 268, 277 (D.C. 2008) ("[A]ppointment of a receiver is an equitable remedy of rather drastic measure.")).

[1016] *Id.* (citing *Case v. Murdock*, 528 N.W.2d 386, 388 (S.D. 1995); *Kuenning v. Broad & High Corp.*, 28 Ohio Misc. 211 (1971); *Hoiles v. Watkins*, 157 N.E. 557 (Ohio 1927)).

[1017] *Id.* (stating that when a receiver is appointed according to equitable principles — rather than being authorized by statute — a higher showing of imminent danger to the property may be necessary).

[1018] *See id.* (noting that "an assignment for the benefit of creditors is based on trust law, sometimes supplemented or modified by a specific state statute"). *See also* Ronald J. Mann, *An Empirical Investigation of Liquidation Choices of Failed High Tech Firms*, 82 Wash. U.L.Q. 1375 (2004) (discussing use of the ABC as an alternative to bankruptcy).

[1019] *See generally* Geoffrey L. Berman, General Assignments for the Benefit of Creditors (second edition) (2006).

[1020] *Id. See also* Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008, at 4 ("An ABC, for example, is regulated by statute and overseen by courts in New York; it is unregulated and requires no court involvement in Illinois.").

[1021] *Compare* Gibbons & Grimes, *supra* note 1011, at 2 (asserting that receivers are able to sell property free and clear without the consent of all lienholders, with some caveats, and acknowledging there is case law to the

well.[1022] In an ABC, any nonconsenting creditors are not bound by any conditions contained in the assignment and the ABC does not displace even the consenting creditors' original claims, unless there is a release.[1023] And even though these nonbankruptcy procedures are generally faster and cheaper, they are also more private and generally less transparent.[1024] This may hide insider self-dealing or preferential treatment of certain creditors.[1025] Nevertheless, the prevailing perception that chapter 11 no longer works for small and middle-market enterprises has forced many companies to consider these alternatives.

2. Definition of SME: Recommendations and Findings

The Commission reviewed the history of the small business debtor provisions and the various proposals to address small business chapter 11 issues that have been proposed in the past, including the NBRC report discussed above and proposals by the Honorable A. Thomas Small of the U.S. Bankruptcy Court for the Eastern District of North Carolina[1026] and the American Bar Association's Select Advisory Committee on Business Reorganizations.[1027] It also considered empirical data, including thoughtful studies by Professor Anne Lawton and Professor Edward Morrison,[1028] and the industry and academic literature analyzing the financial distress of, and restructuring options for, small and middle-market enterprises. Finally, the Commission was aided in its deliberations by witness testimony.

The first question raised by the Commissioners concerned the need for, and the value of, separate chapter 11 provisions for different types of debtors. The Commissioners discussed the very large — or "mega" — chapter 11 cases that often dominated the media headlines. These cases certainly would benefit from the general reform principles proposed by the Commission, but the Commission did not believe that

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contrary), *with* Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 45, at 786–87 (arguing that the liabilities sometimes follow the assets in such asset sales, even when that is not what the parties intended). *See also* Mellen v. Moline Malleable Iron Works, 131 U.S. 352, 367 (1889); Broadway Trust Co. v. Dill, 17 F.2d 486 (3d Cir. 1927); Gibbons, *Lien on Me*, *supra* note 1011, at 19–20.

[1022] *See* Director of Transp. of Ohio v. Eastlake Land Dev. Co., 894 N.E.2d 1255, 1261 (Ohio Ct. App. 2008) (holding that the court did not have the ability to authorize receiver to sell debtor's property free and clear of all liens over the creditor's objection) ("[W]e believe the courts do not have the power in receiver proceedings to take away lien rights in property which were vested by contract or by operation of law without the consent of lien holders.") (citations omitted); Quill v. Troutman Enters, Inc., 2005 WL 994676 (Ohio Ct. App. Apr. 29, 2005) (allowing receiver to sell property free and clear of liens over creditor's objection). *See also* Gibbons & Grimes, *supra* note 1011, at 2; M. Colette Gibbons & Melanie Shwab, Park National Bank *Affirms the Ability of Receivers to Sell Real Property Free and Clear of Liens*, Cleveland Metropolitan Bar J., Dec. 2010, at 14–16.

[1023] Business Organizations with Tax Planning § 156.01.

[1024] Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008, at 8–9 (noting that it may be difficult for creditors to audit the distressed business outside of bankruptcy).

[1025] *Id.*

[1026] *See, e.g.*, A. Thomas Small, *Suggestions for the National Bankruptcy Review Commission: Small Business Reorganization Chapter*, 4 Am. Bankr. Inst. L. Rev. 550, 550 (1996).

[1027] *See* Karen M. Gebbia-Pinett, *Small Business Reorganizations and the SABRE Proposals*, 2 Fordham J. Corp. & Fin. L. 253 (2002).

[1028] Anne Lawton, *Chapter 11 Triage: Diagnosing a Debtor's Prospects for Success*, 54 Ariz. L. Rev. 985, 995–1001 (2012); Morrison, *Bankruptcy Decisionmaking*, *supra* note 998; Morrison, *Bargaining Around Bankruptcy*, *supra* note 1008; Morrison, *Bankruptcy's Rarity*, *supra* note 1008, at 3 (asserting that federal bankruptcy filings account for only three to four percent of all business closures).

targeted chapter 11 provisions would further assist these debtors. The Commissioners also observed the relatively small number of mega cases filed on an annual basis and that many jurisdictions had adopted special local rules to address certain administrative and procedural issues that commonly arise in those cases.[1029]

The Commissioners did not generally believe, however, that a "one-size-fits-all" approach to chapter 11 is the best approach. In addition to the mega cases, the Commissioners found that the general reform principles being proposed identified and responded to key issues for the more established, upper-middle-market and larger company cases. These cases often struggled with liquidity early in the process, timing issues surrounding their exit strategy and value allocation, and case-specific investigations, litigation, or negotiations. These debtors also typically benefit from the advice and counsel of restructuring professionals and have more experienced management teams.[1030]

On the other hand, the Commissioners identified significant and troubling issues for small and lower-to-middle-market enterprises. (These principles refer to these companies as "small and medium-sized enterprises (SMEs).") In working to develop the parameters of companies in this space, the Commissioners discussed companies that have less experienced management teams,[1031] relatively smaller pools of assets and liabilities, relatively smaller revenue streams,[1032] challenges with understanding the

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[1029] *See, e.g.*, Laura B. Bartell, A Guide to the Judicial Management of Bankruptcy Mega-Cases (2d ed. 2009), *available at* http://www.fjc.gov/public/pdf.nsf/lookup/BkMega21.pdf/$file/BkMega21.pdf.

[1030] *First Report of the Commercial Fin. Ass'n to the ABI Comm'n to Study the Reform of Chapter 11: Field Hearing at Commercial Fin. Ass'n Annual Meeting*, at 15–16 (Nov. 15, 2012) ("The "mega" cases and the "pre-arranged" or "pre-pack" cases come to the Bankruptcy Court with many issues having already been pre-negotiated among the various constituencies in the debtor's capital structure. There is often consensus among the debtor and the various creditor groups and their representatives as to financing and management and, indeed, many times even agreement on an exit strategy. These creditor groups are in almost all cases represented by counsel. These cases differ markedly from the typical SME filing where the debtor has had little, if any, contact with any creditors other than its secured lender. Given these differences, and many more not touched upon herein, it seems that in "mega" cases, the consent of the parties should override the normal findings and statutory pre-requisites for such issues as DIP financing and other "first day" decisions, such as the payment of pre-petition obligations (including the payment of "critical vendors"). However, in the non-mega or non-pre-arranged cases, it is necessary to maintain the statutory construction set forth in the Code, tempered by the Court's judicial discretion and the exercise of business judgment."), *available at* Commission website, *supra* note 55.

[1031] Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 427–28 ("Small business managers may be unable to afford adequate managerial training for themselves or their employees, or regularly to hire accountants, bookkeepers, and other professional persons to assist their monitoring efforts. As a result of these factors, they may not discover that their business is in serious financial distress until the situation has deteriorated beyond the point of repair.").

[1032] Small businesses often have higher debt-to-equity ratios than larger firms, and financing tends to come in the form of short-term bank financing for which they generally pay higher interest rates. Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 426 ("As a result of these real limits on obtaining capital, small businesses often confront cash flow problems. Without available funds, they may be unable to exploit market opportunities in their purchase of raw materials and inventory, or to pursue attractive investment opportunities. Cash flow constraints may amplify the ramifications of simple management errors and, in less prosperous times, make small businesses more susceptible to default."); Brian A. Blum, *The Goals and Process of Reorganizing Small Businesses in Bankruptcy*, 4 J. Small & Emerging Bus. L. 181, 194–95 (2000) ("Inadequacy of financial resources, combined with little leverage and market power, can lead to a host of other difficulties such as shortage of operating funds, lack of cash flow, and lack of access to long-term credit. The difficulty in obtaining long-term financing, which leads to heavy reliance on short-term credit (often in the form of credit cards or personal borrowing by the proprietor), is regarded by many writers as one of the most significant reasons for small business failure. Short-term financing allows the business to continue operations without profit for a period of time, but leaves it illiquid and unable to absorb fluctuations in cash flow.").

nature of their financial issues or the potential tools available to help them address those issues,[1033] and vested equity owners who likely either founded the company or help manage the company.[1034] The Commissioners also stressed the importance of these companies possessing viable business models, recognizing that chapter 11 should not be used to delay the inevitable failure of a company. The Commissioners firmly believed, however, that many of these SMEs were failing not because of fatally flawed business models, but because they were not receiving the assistance they needed in the context of a financial restructuring. This belief has been supported by witness testimony and some of the related literature.[1035]

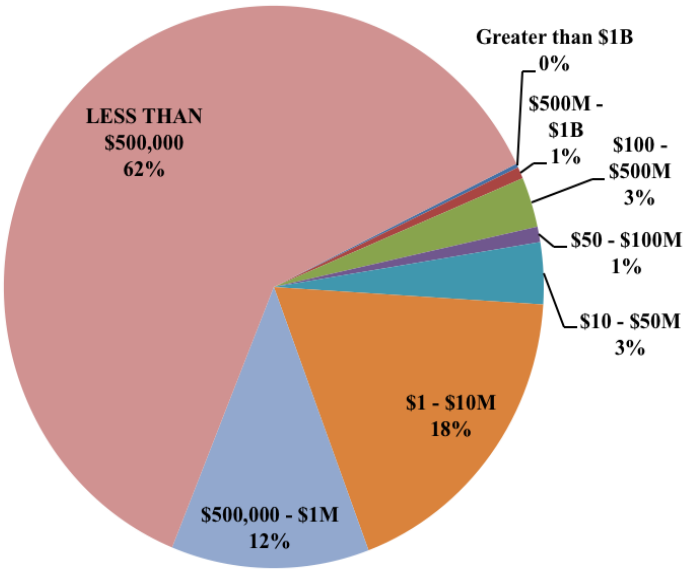
[1033] *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) ("[Small business debtors] often lack the resources to recruit new management or hire experienced insolvency professionals. Their reorganization is also made more difficult by challenges that are common to smaller businesses, such as lack of proprietary products, customer concentration, vendor concentration, difficulty in raising capital, and relative insignificance to many of their lenders and creditors. While it might take the experienced turnaround professional only weeks to determine if the company is a candidate for turnaround and restructuring, the aforementioned circumstances make rehabilitation more challenging and time consuming."), *available at* Commission website, *supra* note 55; Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 426 (noting that small businesses are less likely to have cash reserves and do not have a diverse product line or diverse customer base; also stating that "small business managers may be less likely to detect the symptoms of financial distress at the very earliest stages" because of their short-term perspective); Blum, *supra* note 1032, at 195.

[1034] *See, e.g.*, Haines & Hendel, *supra* note 990, at 85 (noting that small business managers are often the owners and discussing how bankruptcy can be a significant distraction); LoPucki, *The Trouble with Chapter 11*, *supra* note 82, at 758 (noting that the market for small companies is virtually nonexistent because "[w]ithout their owner-managers, most have no value at all"); LoPucki, *The Debtor in Full Control*, *supra* note 999, at 264 (noting that owner-managers exist in a significant majority of all reorganizing companies); Elizabeth Warren, *A Theory of Absolute Priority*, 1991 Ann. Surv. Am. L. 9, 39–42 (1991) (noting that owner-managers of small businesses may be able, despite the absolute priority rule, to retain control of the emerging company by purchasing the equity for new value); Korobkin, *Vulnerability, Survival, and the Problem of Small Business Bankruptcy*, *supra* note 983, at 425 (stating that because of the absolute priority rule, the owner-managers common in small businesses may be reluctant to file a petition before the company is in dire condition because in bankruptcy, they risk losing their financial interests in the business).

[1035] *See, e.g.*, Robert N. Lussier, *Reasons Why Small Businesses Fail*, 1 Entrepreneurial Exec. 10, 11–14 (1996) (noting that there is no agreement on the factors that cause small businesses to succeed or fail but noting that lack of adequate financing is among the most commonly cited factors for failure); Teresa A. Sullivan et al., Financial Difficulties of Small Businesses and Reasons for Their Failure 23–24 (1998), *available at* http://archive.sba.gov/advo/research/rs188tot.pdf; Elizabeth Warren & Jay Lawrence Westbrook, *Financial Characteristics of Businesses in Bankruptcy*, 73 Am. Bankr. L.J. 499, 556–59 (1999) (finding that in a survey of small business debtors, the most cited reason (38.5 percent) for bankruptcy was financing issues such as high debt service, loss of financing, or inability to get financing); *Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 15, 2012) ("Without the historical secured lender coming forward on Day 1, the middle-market Chapter 11 case usually cannot survive until the final hearing. Consequently, those Code provisions, . . . which require the debtor to seek other financing and competitive rates, are in most cases irrelevant because the debtor — in almost all of the cases over which I presided — had difficulty maintaining its existing credit relationships upon the filing of a bankruptcy petition, much less discovering alternative relationships."), *available at* Commission website, *supra* note 55; *Written Statement of Holly Felder Etlin: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–4 (Apr. 19, 2013) ("While the pre and post BAPCPA provisions are necessary for financial markets to function, they did not properly take into account their use as financing vehicles. When the principal lender to a business has the absolute ability to liquidate the assets subject to their agreement, the company is DOA on the steps of the bankruptcy court."), *available at* Commission website, *supra* note 55; *Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) ("[T]he challenges to finance smaller businesses have been well documented, even for those that are making a profit. The challenge is far greater for those companies facing financial stress and for those seeking a DIP loan. Shareholders of smaller companies are also reluctant to lend money, even well documented and at reasonable interest rates, for fear that their loan might be treated as additional equity.

To assess the types of companies within the SME category, the Commission reviewed historical data regarding the types of companies filing for bankruptcy. The Commissioners analyzed data prepared from a database of all business bankruptcy filings (both chapter 7 and chapter 11) maintained by New Generation Research. These data included annual revenue for all but 670 of the 11,261 businesses that filed for chapter 7 or chapter 11 bankruptcy in 2013. These revenue data break down as follows:[1036]

Revenue of Debtors Filing for Bankruptcy in 2013



Note:
Based on the New Generation data, 74% of companies that filed bankruptcies in 2013 had revenue below $1 million. In addition, based on this same dataset, 90% of the companies that filed bankruptcy in 2013 had 50 or fewer employees.

The Commissioners found the revenue and employee information very informative, but they acknowledged that these data points were not readily available on the petition date for any particular debtor. Accordingly, using these measures to define SMEs would be administratively difficult and, although feasible prospectively, such measures would not have the benefit of precedent in terms of interpretation and scope.

Some file without a DIP loan in place, compelling management to spend [an] inordinate amount of time to obtain capital or face liquidation."), *available at* Commission website, *supra* note 55; *Written Statement of Robert Katz: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 15, 2012) ("While seemingly there is more money and more potential lenders/ investors today than ever, it doesn't necessarily trickle down to the middle market. Some middle and lowe-middle-market companies going through a Chapter 11 process are still having trouble attracting capital. . . ."), *available at* Commission website, *supra* note 55.

[1036] Mr. Shrestha prepared this chart for the Commission based on data from the New Generation's Business Bankruptcy Filing Database. Accordingly, it was limited to public and large private companies.

The Commissioners then reviewed data points more readily available for chapter 11 debtors: assets and liabilities. All debtors list these data points in a general manner in the bankruptcy petition and in a more specific manner in the schedules of assets and liabilities. Although also subject to definitional and interpretational issues, courts and practitioners have dealt with these concepts since the inception of the Bankruptcy Code and are more familiar with their application. The Commission asked Professor Anne Lawton to prepare several analyses of chapter 11 debtors' assets and liabilities based on the datasets she built for chapter 11 filings in 2004 and 2007.[1037] The data in Professor Lawton's dataset are taken from a random sample drawn from the population of chapter 11 cases filed in calendar year 2007.[1038] The population includes all chapter 11 cases filed in each of the 94 judicial districts in the United States. Individual and business filers alike are included, as are both voluntary and involuntary cases. The asset and liability data are summarized in the following charts:

DEBTORS' ASSETS BASED ON SCHEDULES			
Asset Ranges	**Number of Cases**	**Percent of Total Number of Cases**	**Cumulative Percent of Cases**
$0 – $ 100,000	111	17.4%	17.4%
$100,001 – $500,000	119	18.6%	36.0%
$500,001 – $1 million	91	14.2%	50.2%
$1,000,001 – $2.19 million	117	18.3%	68.5%
$2,190,001 – $5 million	99	15.5%	84.0%
$5,000,001 – $10 million	47	7.4%	91.4%
$10,000,001 – $50 million	44	6.9%	98.3%
$50,000,001 – $100 million	4	0.6%	98.9%
Over $100 million	7	1.1%	100%
Total	**639**	**100%**	

[1037] Professor Lawton used the same process to create both the 2007 and 2004 datasets. For a more detailed explanation of this process, see Lawton, *Chapter 11 Triage*, *supra* note 1028, at 995–1001.

[1038] The initial sample consisted of 690 cases. The number of chapter 11 cases filed in 2007 was much smaller than that in 2004 and, hence, the population of cases from which the random sample was drawn was smaller. The initial random sample, however, was approximately the same in 2004 and 2007 — in the range of 10.5 percent to 10.8 percent of the respective year's population.

DEBTORS' LIABILITIES BASED ON SCHEDULES			
Liability Ranges	**Number of Cases**	**Percent of Total Number of Cases**	**Cumulative Percent of Cases**
$0 – $100,000	34	5.3%	5.3%
$100,001 – $500,000	111	17.3%	22.6%
$500,001 – $1 million	80	12.5%	35.1%
$1,000,001 – $2.19 million	149	23.2%	58.3%
$2,190,001 – $5 million	126	19.7%	78.0%
$5,000,001 – $10 million	56	8.7%	86.7%
$10,000,001 – $50 million	66	10.3%	97.0%
$50,000,001 – $100 million	8	1.2%	98.3%
Over $100 million	11	1.7%	100%
Total	**641**	**100%**	

The Commissioners carefully analyzed Professor Lawton's data and discussed its implications. They observed a natural breaking point in the data at the $10 million threshold.[1039] They examined the types of companies that might be captured by a definition that included companies with $10 million or less in assets or liabilities. They considered this question based on industry and geographic region, methodically walking through the different companies that could be captured by such a definition. Through this analysis, the Commissioners agreed that public companies (i.e., those with publicly issued debt or equity securities) should be excluded from any SME designation in all instances. Moreover, at the end of these deliberations, the Commissioners determined that the $10 million or less in assets or liabilities standard corresponded with the characteristics identified above of SMEs that are not being well served by current law.

The Commissioners recognized that this standard would capture around 85 percent to 90 percent of the chapter 11 filings, at least based on Professor Lawton's datasets and

[1039] Professor Lawton's 2004 dataset suggests that for *all* chapter 11 filings, 91.6 percent of the debtors had assets (based on schedules) of $10 million or less, and 88.2 percent had liabilities (based on schedules) of $10 million or less. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

adjustments to exclude individual chapter 11 filings (the overwhelming majority of which fall under the $10 million threshold) and any small public companies.[1040] As previously noted, the Commission did not consider reform proposals for individual chapter 11 debtors, and it did not intend individuals to be covered by the recommended principles for SME debtors.

The Commissioners also discussed whether to include any of the factors or qualifications in the current definition of small business debtor. The Commission rejected making the definition overcomplicated and, as such, declined to require liabilities to be "noncontingent" or "liquidated," for example.[1041] It also agreed that a debtor should be able to qualify as an SME based on either assets or liabilities. Nevertheless, the Commission determined that the asset and liability calculations should be performed on a consolidated basis with any affiliates to ensure that smaller businesses within a larger, more complex corporate family were excluded. It further concluded that single asset real estate cases should be excluded from the definition of SME, but that such determinations should be based solely on the single asset real estate definition in section 101(51B) of the Bankruptcy Code.[1042]

Several Commissioners raised two related points: (i) nonpublic companies that do not qualify under this standard based solely on an asset or liability basis may have a very simple business and capital structure that could benefit from the tools and process proposed for small and middle-market enterprises, but (ii) a standard that allowed larger nonpublic companies to qualify for the process also could capture companies with very complex business and capital structures that need to filter through the general chapter 11 process. The Commissioners acknowledged the validity of both scenarios and examined alternatives to appropriately address each. The Commission agreed that nonpublic companies with assets or liabilities in excess of $10 million but less than $50 million should be able to request to be treated as an SME, but that the U.S. Trustee and parties in interest should have the ability to challenge the designation. The Commission also agreed that the court should only grant the request if it is in the best interests of the estate.

The Commissioners used this definition of SMEs and the underlying objectives to develop a comprehensive set of principles to guide and facilitate more effective chapter 11 cases for SMEs. Accordingly, the Commission voted to recommend the adoption of

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[1040] For example, in the 2007 dataset, Professor Lawton was able to identify 171 individual chapter 11 filings with liabilities of $10 million or less. Removing these individual filers (and the four individual filers with more than $10 million in liabilities) from the dataset reduced the percentage of business chapter 11 filings with $10 million or less in liabilities (based on schedules) to 83 percent. Similarly, in the 2004 dataset, the percentage of business chapter 11 filings with $10 million or less in liabilities (based on schedules) drops to 86 percent. *See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

[1041] *See* Lawton, *Chapter 11 Triage*, *supra* note 1028, at 992–93 (explaining complex calculation issues under current definition of "small business debtor").

[1042] The Commissioners did not recommend maintaining the current qualifier in the definition of "small business debtor" in section 101(51D) that the debtor be involved in "commercial or business activities (including any affiliate of such person that is also a debtor under this title and *excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto*)." 11 U.S.C. § 101(51D) (emphasis added). *See also* Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1026 n.149 (explaining challenges in applying real estate exclusion in definition of "small business debtor").

the SME principles and the deletion of the small business debtor and small business case provisions from the Bankruptcy Code.

B. General Application of SME Principles

Recommended Principles:

- A debtor that satisfies the definition of an SME should be subject to the principles set forth herein for SME cases without further action by the court, trustee, or debtor in possession.
- If an objection is timely filed to the debtor's indication in the petition that it qualifies as an SME under the Bankruptcy Code definition, such debtor should be treated as an SME unless and until the entry of an order of the court sustaining any such objection.
- If a debtor timely files a motion seeking to be treated as an SME, such debtor should be treated as an SME only upon the entry of an order of the court overruling any objections thereto and authorizing the debtor's designation as an SME.
- If a debtor qualifies or is designated as an SME, the court may for cause, after notice and a hearing, permit the SME debtor to use good faith estimates in compiling its valuation information package, as required by the principles, if audited or unaudited financial statements are not readily available. The court also may set a deadline by which the SME debtor should turn over its valuation information package, to a requesting party in interest. See Section IV.A.6, *Valuation Information Packages*.
- The general recommended principles proposed for chapter 11 cases apply to SME cases, unless the principles expressly exclude SME cases or would otherwise conflict with the SME principles.

1. General Application of SME Principles: Background

As noted above, Congress introduced the small business provisions into the Bankruptcy Code as an elective process. Debtors who satisfied the original definition of "small business" could elect to proceed with the fast-track plan confirmation procedures. Congress removed the elective nature of the small business provisions in 2005 pursuant to the BAPCPA Amendments. The current provisions mandate small business treatment if, among other things, the debtor has less than $2,190,000 in total secured and unsecured debts and there is no active unsecured creditors' committee in the case.

Although the current small business provisions are mandatory and self-executing, several commentators have suggested that small business debtors are not self-reporting and may not be proceeding as small business cases. For example, Professor Robert Lawless observed that "there were 2,299 chapter 11s filed in 2007 where (i) the debtor was not an individual, (ii) [the debtor] said they had predominately business debts, and (iii) the total liabilities were between $50,000 and $1,000,000. Because very few small chapter 11 cases have unsecured creditors' committees, almost every one of these 2,299

cases should have identified as small business debtor, but only 36.8 percent did so."[1043] Now, the failure to self-identify as a small business debtor may be an oversight, it may be the result of the somewhat complicated definition of "small business debtor" described above, or it may be a desire to avoid the obligations and deadlines imposed on small business debtors under current law. Regardless of the reason, however, the consequences can be significant, including a determination that the small business debtor deadlines apply from the petition date, even if the non-designation is not corrected or is not deemed incorrect by the court until much later in the case.[1044]

2. General Application of SME Principles: Recommendations and Findings

The three primary objectives underlying the Commission's approach to the SME principles were (i) simplifying the process; (ii) reducing costs and barriers; and (iii) providing tools to facilitate effective reorganizations for viable companies. With these objectives in mind, the Commission determined that a hybrid approach to the application of the SME principles would work best. Accordingly, if the debtor is a nonpublic company that satisfies the asset or liability standard, it automatically invokes the SME principles. If the debtor is a nonpublic company that does not qualify, but it has assets or liabilities less than $50 million and believes that the SME principles would better serve its estate and stakeholders, it can make a request to be treated as an SME debtor.

The Commissioners were mindful that some companies might try to manipulate the standard or self-identify as an SME when the standard is not satisfied, but they believed that those concerns are appropriately addressed by allowing the U.S. Trustee and parties in interest to object to the designation in the petition or a debtor's request to be treated as an SME. In both instances, however, the Commissioners understood the importance of these matters being resolved quickly to allow the debtor either the full benefit of the SME principles or appropriate time to consider proceeding under the general chapter 11 principles. They believed that any delay in these determinations could significantly prejudice both the debtor and its stakeholders. The Commission also considered whether debtors would fail to self-report, as some commentators have suggested might be the case under the current law. Again, the Commissioners recognized that this was a possibility, but it believed that the SME principles incorporated appropriate incentives for the debtor and its estate so as to mitigate that risk.

[1043] Bob Lawless, *The Disappearing Small Businesses (Designation) in Bankruptcy*, Credit Slips, (Apr. 30, 2010, 10:26 AM), *available at* http://www.creditslips.org/creditslips/2010/04/the-disappearing-small-businesses-designation-in-bankruptcy.html.

[1044] *See, e.g., In re* Display Grp., Inc., 2010 WL 4777550 (Bankr. E.D.N.Y. Nov. 16, 2010). Notably, the U.S. Trustee reviews a debtor's chapter 11 petition and generally has 30 days following the section 341 meeting of creditors to object to the debtor's designation or non-designation as a small business case. *See* Fed. R. Bankr. P. 1020(b) (2011).

C. Oversight of SME Cases

Recommended Principles:

- The debtor should be permitted to operate as a debtor in possession with all rights, powers, and duties set forth in section 1107 of the Bankruptcy Code and subject to the appointment of a chapter 11 trustee for cause under section 1104.
- A committee of unsecured creditors under section 1102(a) should not be appointed in an SME case unless an unsecured creditor or the U.S. Trustee files a motion with the court requesting the appointment of a committee and the court, after notice and a hearing, determines that the appointment is necessary to protect the interests of unsecured creditors in the case.
- If the debtor does not satisfy the Bankruptcy Code definition of SME but files a timely motion to be treated as an SME in the chapter 11 case, the U.S. Trustee should not appoint a committee of unsecured creditors unless the court denies the debtor's motion. The U.S. Trustee should suspend its ordinary appointment process pending resolution of the debtor's motion.
- If the debtor qualifies as an SME or is designated an SME by the court, the notice of the chapter 11 case served upon creditors should explain that the U.S. Trustee will not appoint a committee of unsecured creditors in the case unless such committee is requested by an unsecured creditor or the U.S. Trustee and the court orders such appointment. If the debtor indicates in its petition that it qualifies as an SME, such notice also should explain that parties in interest have 14 days from the date of such notice to object to the debtor's treatment as an SME.
- The court sua sponte, the U.S. Trustee, the debtor in possession, or a party in interest should be able to request the appointment of an estate neutral that also has the authority to advise the debtor in possession on operational and financial matters, as well as the content and negotiation of its plan. The standard for approval of an estate neutral and the U.S. Trustee's authority to appoint the estate neutral, if ordered by the court, should be governed by the general principles on estate neutrals. See Section IV.A.3, *The Estate Neutral*.
- Any estate neutral should represent the interests of the estate and be paid by the estate. The Bankruptcy Code could establish a fee structure available for the estate neutral in an SME case to control costs and increase certainty. Such structure could be based on the size of the case or the amount of creditor distributions.

1. Oversight of SME Cases: Background

As discussed above, the debtor in possession model used in chapter 11 cases makes oversight of the case particularly important.[1045] In most cases, the Bankruptcy Code

[1045] In the debtor in possession model, the business's prepetition board of directors, officers, and managers continue to manage the company's affairs and make decisions regarding the business and the reorganization. Some critics of the debtor in possession model argue that these prepetition actors contributed to the business's failure and also express concern that the prepetition management may not be aligned with the best interests of the estate. *See* Section IV.A.1, *The Debtor in Possession Model*.

establishes the U.S. Trustee and the committee of unsecured creditors as the statutory watchdogs in the case. Both of these parties have the ability to oversee and investigate certain aspects of the case and to appear and be heard with respect to matters pending in the case.[1046] (In addition, other creditors and equity security holders have standing to appear and be heard in the case under section 1109 of the Bankruptcy Code.) Nevertheless, in many SME cases, the U.S. Trustee may not be able to appoint a committee of unsecured creditors typically because of a lack of creditor interest in serving on the committee.[1047]

The lack of creditor engagement was one reason cited by Congress in using the absence of a committee as a defining feature of a small business case. The legislative history of the BAPCPA Amendments explains:

> Most chapter 11 cases are filed by small business debtors. Although the Bankruptcy Code envisions that creditors should play a major role in the oversight of chapter 11 cases, this often does not occur with respect to small business debtors. The main reason is that creditors in these smaller cases do not have claims large enough to warrant the time and money to participate actively in these cases.[1048]

If an unsecured creditors' committee is not appointed in the small business debtor case, the debtor may drift in its case, achieving little, or it may cede to the desires of its secured creditors, even if those objectives do not align with the best interests of the estate.[1049] Accordingly, although the absence of a committee or creditor engagement may correspond to the size of the debtor or the complexity of the case, it does not mean that the debtor does not need oversight or assistance in the case.[1050]

[1046] For a general discussion of the parties overseeing the debtor in possession in chapter 11, *see* Butler, et al., *supra* note 77. *See also* 11 U.S.C. § 1103 (detailing duties of statutory committees); *id.* § 1104 (appointment of trustee); *id.* § 1109 (explaining standing of parties in interest).

[1047] *See, e.g.*, Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1006 & n. 119 ("The reason for such a low rate of committee formation [in SME cases] is that in most cases an insufficient number of creditors were willing to serve.").

[1048] *See* H.R. Rep. No. 109-31, pt. 1, at 19 (2005), *reprinted in* 2005 U.S.C.C.A.N. 88, 89.

[1049] *See Oral Testimony of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 27 (Apr. 19, 2013) (ASM Transcript) ("[T]he case I worry about is th[e] case . . . with no committee and you have a debtor who is often lock-step with their secured creditor, because they have no choice but to be lock-step with their secured creditor, and there is nobody to tell me when there's a problem in the case."), *available at* Commission website, *supra* note 55; Blum, *supra* note 1032, at 199–201 ("[M]any small business debtors are left to operate too freely in chapter 11 without adequate control [by a unsecured creditors' committee].").

[1050] This concept was a significant motivator for the BAPCPA reforms. Blum, *supra* note 1032, at 201 ("The central component of the proposed [BAPCPA] reform is the creation of an alternative monitoring system to compensate for lack of creditor involvement in the case. In essence, it demands a more aggressive role of the U.S. Trustee and the court as a substitute for the lack of creditor vigilance and increases the accountability of the [small business] debtor by placing greater responsibility on it to provide information about its business affairs and to move with reasonable speed in formulating and obtaining approval of its strategy for rehabilitation.") (citing NBRC Report, *supra* note 37, at 643).

2. Oversight of SME Cases: Recommendations and Findings

The Commission viewed the administrative and oversight functions in an SME case as critical to the utility and effectiveness of the SME principles. The Commissioners wanted to develop principles that encouraged SMEs to file chapter 11 cases when appropriate, which meant reducing costs, simplifying disclosures and the process, and providing a way for the pre-petition managers to stay in control of the business with some financial guidance and counseling when needed. These factors allowed the Commissioners to reflect on various alternatives for structuring the SME principles, including a chapter 13-like process for SMEs.

Some Commissioners suggested that the best oversight for SME cases was a standing trustee system similar to that used in the chapter 13 context. In chapter 13 cases, the U.S. Trustee appoints a standing trustee in each jurisdiction. The trustee represents the estate, and he or she oversees the administration of the case, including the confirmation of, and distributions under, the debtor's rehabilitation plan. The trustee does not represent the debtor, but he or she may consult with the debtor, including with respect to issues in the proposed rehabilitation plan. A few Commissioners even suggested either raising the chapter 13 debt limits to permit small businesses to file under chapter 13 or incorporating a more chapter 13-like process into chapter 11 for small businesses.[1051]

Most Commissioners strongly rejected the notion of either a standing trustee for SMEs or a chapter 13-like process for SME cases. These Commissioners noted that small business cases are not simply big chapter 13 cases. They highlighted the structural differences in business cases, including the debtor's contractual relationships with vendors and suppliers and its obligations to customers. SMEs also have employees to consider and operational issues that may complicate their restructuring alternatives. Finally, these Commissioners highlighted the likely reluctance of SMEs to file bankruptcy cases if the administration of their cases and perhaps their businesses would be turned over to a standing trustee.

The Commissioners then considered whether the traditional unsecured creditors' committee structure was an effective oversight mechanism for SME cases. They reflected on the witness testimony concerning the costs associated with unsecured creditors' committees, particularly in smaller cases.[1052] They also noted the creditor apathy that might prevent the formation of a committee in the first instance in SME cases.[1053] Most Commissioners agreed that committees could be effective in SME cases

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[1051] For a similar proposal that would create a process similar to chapter 12 for small business debtors, *see* Haines & Hendel, *supra* note 990.

[1052] *See Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) (citing professionals' fees associated with unsecured creditors' committees as one of the bankruptcy process obstacles facing small business debtors), *available at* Commission website, *supra* note 55.

[1053] *See, e.g.*, Lawton, *Chapter 11 Triage*, *supra* note 1028, at 1006 & n. 119; Honorable A. Thomas Small, *Small Business Bankruptcy Cases*, 1 Am. Bankr. Inst. L. Rev. 305, 320–21, 320 n. 74 (1993) ("In most cases, however, unsecured creditors are apathetic and creditors' committees are ineffective, particularly in smaller Chapter 11 cases. Removing the creditors' committee would, however, benefit the debtor by eliminating the possibility that a creditors' committee might incur substantial professional fees that could easily jeopardize confirmation of the debtor's plan.").

if creditors were engaged and representative of the general unsecured creditor body, and if costs could be contained. They also agreed, however, that satisfying both of these criteria in an SME case was likely the exception rather than the rule.[1054]

The Commissioners analyzed whether an estate neutral might provide appropriate oversight in SME cases when a committee was not appointed and when the SME debtor needed monitoring or assistance.[1055] They reviewed the witness testimony on the types of tools that witnesses believed would be helpful to SME debtors. For example, the Honorable Barbara J. Houser of the U.S. Bankruptcy Court for the Northern District of Texas suggested that "a third party who is more of a financial person, who could come in and evaluate the viability of the business,"[1056] may be of assistance to both the court and the debtor in possession in assessing the debtor's prospects for reorganization. Several Commissioners observed that the estate neutral concept might apply particularly well in SME cases. The court could appoint an estate neutral for specific purposes, including a financial review of the debtor, consulting with the debtor concerning its finances and restructuring options, or investigating the debtor's affairs when necessary or appropriate. The estate neutral, with court authority, also could assist the SME debtor in developing its chapter 11 plan, which would provide oversight of the debtor in possession and a counterbalance to any particular individual creditor influence in the case. Although the estate neutral would impose an additional cost on the estate, the Commissioners believed that the courts could and should closely monitor the fees and expenses of the estate neutral and could even use caps or budgets to protect the estate.

On balance, the Commission voted to recommend the use of estate neutrals to assist SME debtors achieve effective outcomes in appropriate cases. The Commissioners underscored the case-by-case nature of this inquiry and, accordingly, declined to make it a mandatory appointment. They specifically found, however, that if the court orders the appointment of an estate neutral, the U.S. Trustee should be the party responsible for the appointment of the neutral to ensure objectivity and fairness in the process. The Commission also determined that the U.S. Trustee and parties in interest should be able to request the appointment of a committee in an SME case. As noted above, if there is creditor interest, a committee may be very valuable in an SME case. Nevertheless, the Commissioners found no basis for the existence (or non-existence) of a committee to affect an SME designation. They also believed that the cost of, and the historical issues with, appointing a committee in smaller cases supported a default rule of no committee appointment.

[1054] *See id.*

[1055] *See, e.g., Written Statement of Gerald Buccino: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 3, 2012) (stating that it could take an experienced turnaround professional only a few weeks to determine if a debtor's business is viable, whereas it would likely take an unassisted small business debtor much longer), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Melanie Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2–3 (Nov. 15, 2012) (noting there is very little oversight in most small business cases and that these cases seem to "live" from one emergency to the next), *available at* Commission website, *supra* note 55.

[1056] *Oral Testimony of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 29 (Apr. 19, 2013) (ASM Transcript), *available at* Commission website, *supra* note 55.

D. Plan Timeline in SME Cases

Recommended Principles:

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

1. Plan Timeline in SME Cases: Background

The Bankruptcy Code, as amended in 2005, requires that a debtor's chapter 11 plan be confirmed within 45 days of its filing. Several witnesses before the Commission testified that this is nearly impossible for small business debtors to achieve.[1057] Although it is possible to obtain a continuance, one witness noted that the burden for doing so is quite high, and that there is confusion regarding what the court must find and how it must make the necessary determinations, given the tight timelines and significant requirements.[1058] Thus, practically speaking, even viable small business debtors face considerable challenges to confirming a plan.

The Bankruptcy Code also provides that a small business debtor must file the chapter 11 plan within 300 days of the petition date.[1059] One witness noted that the 300-day deadline creates interpretive and practical problems similar to those identified above for the 45-day deadline, plus gives rise to additional concerns.[1060] For example, confusion exists regarding the application of the provision to parties other than the debtor, and the Bankruptcy Code does not specify the effect of an amended plan.[1061]

[1057] *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), *available at* Commission website, *supra* note 55; *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) ("[E]ven when these [small and medium-sized] businesses make it to a confirmation hearing, the challenges they face may be virtually impossible to overcome."), *available at* Commission website, *supra* note 55.

[1058] *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 4–6 (Apr. 19, 2013), *available at* Commission website, *supra* note 55. *See also* 11 U.S.C. § 1129(e) (providing that the court shall confirm a plan within 45 days for small businesses, unless time is extended in accordance with section 1121(3)(3)); *id.* § 1121(e) (3) ("[T]he time periods . . . may be extended only if — (A) the debtor, after providing notice to parties in interest (including the United States trustee), demonstrates by a preponderance of the evidence that it is more likely than not that the court will confirm a plan within a reasonable period of time; (B) a new deadline is imposed at the time the extension is granted; and (C) the order extending time is signed before the existing deadline has expired.").

[1059] 11 U.S.C. § 1121(e) ("In a small business case . . . the plan and a disclosure statement (if any) shall be filed not later than 300 days after the date of the order for relief . . . .").

[1060] *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 6–7 (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

[1061] *Id.*

The Bankruptcy Code also does not address the consequences for failure to submit a plan by the 300-day deadline.[1062]

2. Plan Timeline in SME Cases: Recommendations and Findings

The Commissioners debated the utility of firm deadlines in the context of SME cases. They understood the need to assess the viability of a debtor earlier rather than later in the case; no party benefits from prolonging a dismissal and incurring additional costs and expenses that cannot be paid. They also discussed the danger of handcuffing debtors to artificial deadlines that might not facilitate the debtor's reorganization or serve the interests of the estate in the particular case.

The Commission reviewed the recommendations of the advisory committee, which focused on helping both viable and nonviable debtors reach their fate efficiently. The advisory committee's recommendations included simplifying the definition of "small business debtor," and eliminating the 300-day plan proposal and 45-day plan confirmation deadlines for small business cases. The Commission also considered reforms suggested by witnesses, including more discretion for bankruptcy judges concerning the procedures in small business cases,[1063] and additional clarification regarding the standard of review and procedural requirements if the current 45- and 300-day confirmation and plan deadlines remain in place.[1064]

The Commissioners worked to develop a process striking an appropriate balance between the need to assess the viability of an SME debtor case early while still allowing viable SME cases a reasonable opportunity to succeed. The Commission voted to recommend a mandatory requirement that the SME debtor file a timeline for filing and soliciting acceptances of its chapter 11 plan within 60 days of the petition date. It set this deadline to allow time for the SME debtor to settle into the chapter 11 case, resolve any issues relating to its SME designation, and consult with any committee or estate neutral appointed in the case, but still allow the court time to develop deadlines for the filing and solicitation of a chapter 11 plan consistent with other provisions of the Bankruptcy Code, such as the debtor's exclusivity periods under section 1121. The Commission determined that section 105(d) (2)(B) adequately authorizes the court to

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[1062] Although the Bankruptcy Code does not address the consequences of the failure to file a plan within the 300-day period, "the consensus appears to be that if no party files a plan within the 300-day period, no relief can be afforded and the case must be dismissed." *Id.*

[1063] *Written Statement of the Honorable Melanie L. Cyganowski (Ret.), former Chief Bankruptcy Judge, Eastern District of New York: CFA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3 (Nov. 15, 2012) ("[I]t is essential that the Bankruptcy Court have flexibility to exercise judicial supervision regarding the SME debtor's business judgment when dealing with secured credit. The reasons are many but in most instances, these middle-market cases seemingly 'live' from one emergency to the next and therefore legislating 'fixed' criteria when it comes to the treatment of secured debt would not be in the best interest of promoting reorganization. It is not at all unusual in these middle-market Chapter 11 cases for a deadline or a budget requirement to be missed which, but for the Court's intervention and ability to step in and permit the waiver of an otherwise arbitrary provision, would lead to the automatic lifting of the automatic stay or the dismissal of the case without hearing or opportunity to be heard."), *available at* Commission website, *supra* note 55.

[1064] *Written Statement of the Honorable Dennis Dow: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 3–7 (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

establish these deadlines, and that the Bankruptcy Code should be amended to simply require the court to exercise this authority in SME cases.

E. Plan Content and Confirmation in SME Cases

Recommended Principles:

- A chapter 11 plan in an SME case should provide for the following treatment of allowed claims and interests in the case:
  - Payment of all administrative and priority claims in accordance with section 1129(a)(9) of the Bankruptcy Code.
  - Bifurcation of each undersecured claim into an allowed secured claim in accordance with section 506 and a general unsecured claim for any deficiency claim; neither section 1111(b) nor section 1129(a)(7)(B) should apply in an SME case.
  - Distributions to secured creditors (i) as provided in the plan and accepted by each class of secured creditors; or (ii) in accordance with section 1129(b)(2)(A).
  - Distributions to unsecured creditors (i) as provided in the plan and accepted by each class of unsecured creditors; (ii) in accordance with section 1129(b)(2)(B) (subject to the recommended principles codifying the new value corollary); or (iii) as provided below for an SME Equity Retention Plan. See Section VI.C.2, New Value Corollary.
  - Pre-petition equity interests may receive voting common stock or ownership units in the reorganized debtor, provided that (i) all impaired classes have accepted the plan; (ii) the plan complies with section 1129(b) (subject to the recommended principles codifying the new value corollary); or (iii) the plan complies with section 1129(b)(2)(A) and provides impaired classes of unsecured creditors that have rejected the plan with preferred stock, or similar economic interests, in the reorganized debtor as described below (an "SME Equity Retention Plan").
- The court should confirm an SME Equity Retention Plan that is not accepted by any class of unsecured claims only if:
  - (i) The pre-petition equity security holders will continue to support the debtor's successful emergence from chapter 11 by remaining involved, on a basis reasonably comparable to their pre-petition involvement, in the ongoing operations of the reorganized debtor; and (ii) the reorganized debtor will pay to the holders of unsecured claims, no less often than annually, its excess cash flow calculated in a manner reasonable in relation to the company's operating cash flow for each of the three full fiscal years following the effective date of the chapter 11 plan. The debtor should file a budget with its disclosure statement and chapter 11 plan that describes the excess cash flow calculation method and includes projections of excess cash flow for the three fiscal years following the effective date of the plan.
  - The pre-petition equity security holders receive or retain 100 percent of the common stock, or similar ownership interests, issued or outstanding

as of the effective date entitling the holders as a class to receive 15 percent of any economic distributions from the reorganized debtor, including dividends, liquidation or sale proceeds, merger or acquisition consideration, or other consideration distributed to the economic owners of the reorganized debtor.

o The pre-petition unsecured creditors as a class receive 100 percent of a class of preferred stock, similar preferred interests, or payment obligations issued by the reorganized debtor on the effective date in accordance with the chapter 11 plan with the following features (referred to as the "creditors' preferred interests"): (i) pro rata voting rights, limited to voting only on the extraordinary transactions identified in these principles; and (ii) entitlement as a class to receive 85 percent of any economic distributions from the reorganized debtor, including dividends, liquidation or sale proceeds, merger or acquisition consideration, or other consideration distributed to the economic owners of the reorganized debtor.

o The creditors' preferred interests mature on the fourth anniversary of the effective date, at which time the interests should convert into 85 percent of the common stock, or similar ownership interests, of the reorganized debtor, unless redeemed in cash on or before the maturity date for their full face amount. The face amount of the creditors' preferred interests should equal the amount of the allowed unsecured claims held by those creditors receiving the creditors' preferred interests and established under the plan or confirmation order. Any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to the maturity date should reduce the redemption or conversion value of such interests.

o The following kinds of post-effective date transactions are deemed "extraordinary transactions" subject to the vote of holders of creditors' preferred interests: (i) any change to the compensation of, or payments to, insiders of the reorganized debtor as set forth in the chapter 11 plan, including any compensation or payments to or for the benefit of relatives or affiliates of such insiders; (ii) dividends or other distributions of value to equity security holders of the reorganized debtor; (iii) decisions to forego or roll over any dividends or other distributions of value required to be paid under the organizational documents on account of the economic ownership interests held by holders of creditors' preferred interests; (iv) the sale of all or substantially all of the assets of the reorganized debtor, dissolution of the reorganized debtor, or merger of the reorganized debtor with or its acquisition of another entity; and (v) any amendments to the organizational documents that would modify, alter, or otherwise affect the rights of holders of creditors' preferred interests. An extraordinary transaction should require at least an absolute majority vote of the holders of creditors' preferred interest, but the chapter 11 plan may require a higher level of approval. Whether an extraordinary transaction has been approved

by the requisite majority vote (or such higher level as required by the plan) should be determined in accordance with applicable state entity governance law.

o The consummation of an extraordinary transaction without the requisite approval should constitute a default under the chapter 11 plan, and holders of creditors' preferred interests should have the ability to request appropriate relief for such breach from the court that confirmed the plan. In addition, upon any such default, the creditors' preferred interests should be entitled to a liquidation preference over the common stock in the full face amount of the creditors' preferred interests, reduced by any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to liquidation.

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

1. Plan Content and Confirmation in SME Cases: Background

Many commentators agree that chapter 11 is failing for small business debtors, but they disagree on both the cause and solution to this problem. As discussed above, some suggest that the deadlines concerning the plan process pose significant barriers. Others suggest that the plan process itself and the confirmation standards make emergence from chapter 11 almost impossible for small business debtors.[1065] Still, others have posited that reorganization is simply not feasible for small business debtors, benefits only the business owner, and that going concern sales may be a more effective restructuring option for these debtors.[1066]

The Commission received testimony from several witnesses arguing that the absolute priority rule[1067] and courts' disparate treatment of the new value corollary doom many small business debtors' plans.[1068] As Judge Houser explained:

[1065] *Id*. at 1 ("The complexity, time and costs of the Chapter 11 process impose obstacles that small businesses often cannot overcome."); *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1 (Apr. 19, 2013) ("As Judge Dow has already observed, the complexity, time, and costs of the Chapter 11 process impose obstacles that small and middle-market businesses often cannot overcome. But, even when these businesses make it to a confirmation hearing, the challenges they face may be virtually impossible to overcome."), *available at* Commission website, *supra* note 55.

[1066] Baird & Rasmussen, *The End of Bankruptcy*, *supra* note 45, at 753, 786–89 (2002) (noting that Sweden's insolvency code only provides for the sale of an insolvent firm and that it works well for both large and small businesses, and that many such small business debtors are run by "marginally competent owner-managers" with few corporate assets and few long-term employees). *See also* Douglas G. Baird & Edward R. Morrison, *Serial Entrepreneurs and Small Business Bankruptcies*, 105 Colum. L. Rev. 2310 (2005) ("The typical Chapter 11 debtor is a small corporation whose assets are not specialized and rarely worth enough to pay tax claims. There is no business worth saving and there are no assets to fight over. The focal point is not the business, but the person who runs it.").

[1067] The absolute priority rule is implicated when there is an undersecured creditor who rejects the debtor's plan. This undersecured creditor receives a lot of power in this circumstance because the creditor's claim is bifurcated such that the creditor is able to vote in the secured class *and* the unsecured class. The small business debtor likely has only a few classes of claims. This ultimately makes the plan very difficult to confirm under the cramdown provisions. *Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–2 (Apr. 19, 2013), *available at* Commission website, *supra* note 55.

> So, where a small to mid-sized business debtor cannot pay its unsecured claims in full with a market rate of interest over the life of the plan (a common occurrence), the junior class of interest holders may not receive or retain any property under the plan "on account of " their former interests. This is because of the application of what we call the absolute priority rule. The application of this rule and the so-called "new value exception" to it in small to mid-size Chapter 11 cases proves problematic.[1069] Witnesses suggested that this uncertainty in the plan process can cause delay and expense, and can even deter filings in the first instance.[1070]

2. Plan Content and Confirmation in SME Cases: Recommendations and Findings

A debtor's emergence from chapter 11 frequently turns on its ability to confirm a chapter 11 plan. Although it may consider a sale of all or substantially all of its assets under section 363x as an exit strategy, a debtor — particularly an SME who likely has founders or managers as part of its pre-petition ownership structure — strives to reorganize and emerge from chapter 11 as a stronger and more efficient version of its pre-petition business.

The Commission considered at length the interests of an SME's pre-petition stakeholders and the challenges to confirmable plans for SME debtors.[1071] The Commissioners acknowledged that many SMEs are family-owned businesses or businesses in which the founders are still actively involved.[1072] For this reason, many SMEs find the common result of plan confirmation extinguishing pre-petition equity interests in their entirety unsatisfactory or completely unworkable. The Commissioners discussed the tension created by these expectations: pre-petition equity views their contributions and continued participation as necessary to the reorganization, but

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[1068] The new value exception presents problems in small business cases because there may be tension between the oversecured creditor and the owner-operators (equity security holders). These equity security holders may give new value to retain some stake in the reorganized business. However, there may be challenges in appropriately applying the new value exception in small business cases. *Id.* at 2–6.

[1069] *Id.* at 2. *See also Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 9 (Nov. 3, 2012) ("Inclusion of limited exclusivity and the implementation of the absolute priority rule in the bankruptcy regime make the most sense with respect to large public entities whose creditors and equity holders made informed investment decisions and understood their risk and relative priorities. I am not sure that the considerations are the same with respect to smaller businesses. Should entrepreneurs and families who are involved in the day to day operations of their businesses be provided some level of protection not available to holders of securities in public companies?"), *available at* Commission website, *supra* note 55.

[1070] *Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 9 (Nov. 3, 2012) (suggesting that small businesses that are managed by equity security holders delay filing because of the personal financial detriment that such filings will cause them), *available at* Commission website, *supra* note 55.

[1071] *See, e.g., Written Statement of the Honorable Barbara Houser: ASM Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 1–6 (Apr. 19, 2013) (discussing how the absolute priority rule and the new value exception create challenges in the bankruptcies of owner-operated small businesses), *available at* Commission website, *supra* note 55.

[1072] *See, e.g., Written Statement of Richard Mikels: TMA Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 13 (Nov. 3, 2012) ("While it is beneficial that value is being realized for creditors, the blood, sweat and tears of the owners are not being accorded the [appropriate] considerations [which affect the use of chapter 11 by small businesses]."), *available at* Commission website, *supra* note 55.

stakeholders may hold a very different perspective. Pre-petition equity or managers may be considered part of the problem or ineffective.

The Commissioners debated how best to mitigate this tension and foster a meaningful reorganization process for SMEs. Most Commissioners agreed that the SME principles should include some option for pre-petition equity security holders to retain or receive the equity of the reorganized debtor, beyond that currently permitted under the new value corollary. These Commissioners asserted that SMEs needed a reorganization path that encouraged founders and pre-petition equity not only to invoke chapter 11, but also to devote all of their efforts to the debtor's successful reorganization. Indeed, for many SMEs — whether stakeholders like them or not — the pre-petition founders or managers often possess the knowhow and relationships necessary to facilitate a successful restructuring of the business.[1073]

The Commissioners determined that the SME principles should create an equity retention structure that would appropriately align the interests of pre-petition management and equity with the debtor's reorganization and protect the interests of unsecured creditors, despite noncompliance with the traditional absolute priority rule. The basic elements of this structure include:

- A reorganized capital structure that (i) permits pre-petition equity to retain or receive 100 percent of the voting interests in the reorganized debtor, subject to the limited voting rights of the creditors' preferred interests, and no more than 15 percent of the economic ownership interests in the reorganized debtor (akin to common stock ownership with limited economic rights); and (ii) grants preferred ownership interests to general unsecured creditors that include limited voting rights on extraordinary transactions and at least 85 percent of the economic ownership interests in the reorganized debtor (creditors' preferred interests).
- A provision in the plan that directs the reorganized debtor to pay to the holders of unsecured claims, no less often than annually, its excess cash flow calculated in a manner reasonable in relation to the company's operating cash flow for each of the three full fiscal years following the effective date of the chapter 11 plan. This provision is intended to provide cash dividends to unsecured creditors prior to maturity of the preferred interests and to fairly allocate the reorganized debtor's excess cash to claims impaired by the chapter 11 plan.
- The creditors' preferred interests mature on the fourth anniversary of the effective date of the chapter 11 plan, at which time the interests should convert into 85 percent of the common stock, or similar ownership interests, of the reorganized debtor, unless redeemed in cash on or before the maturity date for their full face amount. The face amount of the creditors' preferred interests should equal the amount of the allowed unsecured claims held by those creditors receiving the creditors' preferred interests and established under the

[1073] *Written Statement of Maria Chavez-Ruark: CFRP Field Hearing Before the ABI Comm'n to Study the Reform of Chapter 11*, at 2 (Nov. 7, 2012) ("[I]n smaller Chapter 11 proceedings the debtor's competitive advantage is [often] based on the owners' relationships with customers, suppliers or others."), *available at* Commission website, *supra* note 55.

plan or confirmation order. Any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to the maturity date should reduce the redemption or conversion value of such interests.

- The holders of creditors' preferred interests are entitled to vote on any and all of the following extraordinary transactions: (i) any change to the compensation of, or payments to, insiders of the reorganized debtor as set forth in the chapter 11 plan, including any compensation or payments to or for the benefit of relatives or affiliates of such insiders; (ii) dividends or other distributions of value to equity security holders of the reorganized debtor; (iii) decisions to forego or roll over any dividends or other distributions of value required to be paid under the organizational documents on account of the economic ownership interests held by holders of creditors' preferred interests; (iv) sale of all or substantially all of the assets of the reorganized debtor, dissolution of the reorganized debtor, or merger of the reorganized debtor with or its acquisition of another entity; and (v) any amendments to the organizational documents that would modify, alter, or otherwise affect the rights of holders of creditors' preferred interests. This provision is intended to protect the value of, and entitlement to, the cash, creditors' preferred interests, and other distributions allocated to unsecured creditors under the plan from diminution or impairment by the postconfirmation actions of common interest-holders, managers, or insiders. The failure to adhere to the voting or other rights granted to holders of creditors' preferred interests under or in connection with the plan constitutes a default under the plan that may be enforced in the bankruptcy court. In addition, upon any such default, the creditors' preferred interests should be entitled to a liquidation preference over the common stock in the full face amount of the creditors' preferred interests, reduced by any cash or other distributions received by the holders of the creditors' preferred interests (whether under the plan on account of their unsecured claims or on account of the creditors' preferred interests) prior to liquidation.
- Finally, the pre-petition equity must commit to support the plan, the debtor's emergence from chapter 11, and its postconfirmation operations.

The Commission voted to recommend an equity-retention plan structure built on these basic elements. It believed that such a structure will provide appropriate incentives and protections, basically giving pre-petition equity security holders four years after confirmation to repay the business's pre-petition unsecured creditors. If the pre-petition equity security holders are not able to achieve this result in that time period, then the unsecured creditors may convert their preferred interests into common ownership interests, significantly diluting the common ownership held by the pre-petition equity security holders. Under this structure, both pre-petition equity security holders and unsecured creditors have incentives to foster a sustainable and profitable reorganized business.

Finally, the Commissioners recommended other modifications to the section 1129(a) confirmation standards, including a mandatory bifurcation of undersecured creditors' claims so that only the allowed secured claim of such creditor would be subject to the cramdown requirements of section 1129(b)(2)(A), and its unsecured deficiency claim would be subject to the treatment provided general unsecured creditors. In addition, certain other modifications proposed by these principles to plan confirmation requirements for all chapter 11 cases would apply to SME cases, such as the elimination of an accepting impaired class of creditors under section 1129(a)(10). Notably, the Commission did not recommend application of the redemption option value principles to SME cases.[1074]

CONCLUSION

The Commission's process revealed a growing consensus for the reform of chapter 11. Although not every witness who testified or professional who worked on the project agreed with this broad statement or on the particular aspects in need of reform, most identified general areas of chapter 11 practice that no longer work as effectively as possible. Moreover, the field hearings and the Commission's research found that these deficiencies in chapter 11 are having an adverse impact on distressed companies and their stakeholders, particularly with respect to small and medium-sized enterprises.

Overall, the Commission concluded that the Recommended Principles, when taken in concert, would significantly improve chapter 11 and make it a more viable and effective restructuring option for distressed companies of all sizes, including small and medium-sized enterprises. The Commission believed that its process was thorough, inclusive, transparent, and robust. This Report sets forth as fully as possible the issues; the different perspectives on those issues; the relevant research (including witness testimony, academic literature, empirical studies, and case law); and the Commission's deliberations, findings, and recommendations. The Commission hopes that the Report not only further informs the dialogue surrounding chapter 11 reform and leads to spirited debate on the issues, but also that it leads to serious consideration and adoption by policymakers of many, if not all, of the Recommended Principles in the Report.

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[1074] For a discussion of the redemption option value principles and the potential challenges to applying them in SME cases, see Section VI.C.1, *Creditors' Rights to Reorganization Value and Redemption Option Value*.