ABI Commission Report: Proposed Amendments and Their Impact on Valuation

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Valuation is a central element of most chapter 11 cases. It helps identify the best use of the assets, and it determines distributions among stakeholders. It also forms the foundation of the debtor's reorganization plan. Yet, the rules on valuation are somewhat vague and subjective, and the information necessary to perform the valuation is often difficult to discern.

The America Bankruptcy Institute's Commission to Study the Reform of Chapter 11 (the "Commission") recognized the importance of, and challenges to, valuation issues in chapter 11 cases. It devoted a separate topical advisory committee to the issue of valuation, and valuation issues permeated the work of other advisory committees, such as those studying sales under section 363 of the Bankruptcy Code, adequate protection and debtor in possession ("DIP") financing, and plans of reorganization. The Commission itself also studied the issues, reviewing countless cases, empirical studies, and law review articles. The Commission's *Final Report and Recommendations* (the "*Final Report*"), issued in December 2014, sets forth the Commission's findings and proposed recommendations on, among other things, valuation issues in chapter 11 cases.[1]

These materials first summarize the Commission's recommendations on valuation, providing relevant background and justifications for the proposals. They then discuss a few notable cases addressing issues at the core of valuation disputes. Finally, the materials suggest some areas for further consideration in light of the Commission's *Final Report* and the increasing complexity of valuation issues in chapter 11 cases.

I. The ABI Commission's Key Valuation Recommendations

Valuation Information Packages. Valuation issues arise early in chapter 11 cases. In fact, their import may come to light before the case is even filed in the context of negotiating DIP financing and cash collateral packages. Understanding the debtor's business and capital structure, as well as the claims asserted against the debtor's assets by creditors, is critical to even estimating the value of the debtor. Yet, much of the information necessary to perform a

[1] FINAL REPORT AND RECOMMENDATIONS OF THE ABI COMMISSION TO STUDY THE REFORM OF CHAPTER 11, Dec. 2014, *available at* www.commission.abi.org. The sections of the *Final Report* discussed in these materials are attached at the Appendix.

valuation is not disclosed in the debtor's bankruptcy petition. Moreover, a debtor typically does not disclose such information until valuation is contested, for example in the adequate protection or plan context. But how does a creditor, a committee, or the United States trustee identify a valuation issue without the information necessary to perform the valuation?

The Commission recognized this "chicken and egg" problem and recommended requiring a debtor to compile certain valuation information at the beginning of the case and to disclose a list of that information upon the filing of any motion "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."[2] The Commission referred to this information as a "valuation information package" or "VIP" and indicated that any VIP should include: "(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 prepetition creditors and existing or potential purchasers, investors, or lenders, all business plans or projections prepared within the past two years."[3] Moreover, upon the request of a party in interest and subject to certain protections, the proposal requires the debtor to provide such party with a copy of the VIP. As the *Final Report* explains, "[t]he 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."[4]

Adequate Protection. The court and the parties may first confront valuation issues in the context of adequate protection. The adequate protection question may relate to, for example, a debtor's request to use cash collateral or other property of the estate under section 363 of the Bankruptcy Code or to prime the interests of a prepetition lender under section 364 of the Bankruptcy Code. The basic concept of adequate protection protects the value of a secured creditor's interest in the debtor's property from diminution during the chapter 11 case. The actual determination of the value of a secured creditor's interest in the debtor's property and the likelihood and extent of diminution, however, is difficult.

The Commission sought to clarify the adequate protection process in chapter 11 by clarifying the timing of the valuation, the appropriate valuation standard, and what might constitute adequate protection in certain cases. The Commission recommended valuing the secured creditor's interest in the debtor's property at the time of any request for, or agreement concerning, adequate protection. This valuation should assess the interest based on the "foreclosure value" of the secured creditor's collateral. Notably, foreclosure value does not mean liquidation value. Rather, the Commission defined foreclosure value as: "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."[5] The Commission's proposal endeavors to value the secured creditor's interest based on what the

[2] *Id.* at 45.
[3] *Id.*
[4] *Id.* at 47.
[5] *Id.* at 67.

secured creditor would have recovered under applicable nonbankruptcy law had the bankruptcy case not been filed.

The Commission did not believe, however, that the foreclosure value of the secured creditor's collateral should govern valuation in all instances. The Commission underscored the importance of using foreclosure value for adequate protection purposes, which often arise early in a case, and then using reorganization value for distributional purposes. The Commission defined reorganization value as "(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."[6] Moreover, the proposal would allow the secured creditor under certain circumstances in which adequate protection fails to require the debtor or trustee to sell its collateral under section 363 of the Bankruptcy Code.

General Valuation Determinations. The court decides most valuation disputes in chapter 11 cases; an approach referred to as judicial valuation. Critics of judicial valuation suggest that it introduces uncertainty into the process and that judges may not have sufficient experience with valuation methodology. After reviewing the advantages and disadvantages to judicial valuation and alternative approaches, the Commission concluded that judicial valuation was not only appropriate, but also added value to the process in many cases. It also underscored the court's ability to appoint a valuation expert. "The Commission found continued utility in the judicial valuation approach, including the flexibility it gives the parties in selecting the best valuation method."[7]

Redemption Option Value. The Commission recognized that the amount of creditor distributions turns on the debtor's valuation. Importantly, that valuation can vary not only based on the method used, but also on factors such as the timing of the valuation, the cyclical nature of the debtor's business, and the state of the debtor's industry or the economy more generally. Accordingly, the Commission was concerned about static valuations done, for many debtors, at the lowest point in their economic lifecycle. The Commission also recognized that this aspect of chapter 11 valuation intensifies when creditors who stand to benefit from a particular valuation influence the timing of the valuation and the debtor's exit from chapter 11.

To mitigate this timing issue, the Commission proposed using a more nimble valuation tool to determine allocations to senior and junior creditors in chapter 11 cases.[8] Under the Commission's proposal, the value of the debtor for allocation purposes would be determined using an option formula under which the strike price is the full face amount of the senior debt

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[6] *Id.* at 207.
[7] *Id.* at 182.
[8] *Id.* at 207. *See also* Donald S. Bernstein and James E. Millstein, *ABI Commission: Redemption Option Value Explained*, AM. BANKR. INST. J., June 2015 (attached at Appendix).

(including any deficiency claims and interest at the non-default rate) and the term is three years beginning on the petition date. The Commission believed that such an option approach would provide a more robust and equitable valuation of the debtor. Importantly, the Commission did not propose granting junior creditors an option in the debtor or its assets; rather, the option formula is simply a valuation tool in the distributional context.

The Commission acknowledged that further work needs to be done regarding the details and implementation of this redemption option value concept. That said, the Commission's objective is clear: If the redemption option value is sufficient to pay the senior creditors' claims in full, then any value above that amount should be allocated to the immediately junior class of creditors. "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."[9]

Cramdown Interest Rate. The Commission also analyzed the appropriate discount rate for purposes of calculating the present value of any deferred cash payments being made to the secured creditors under section 1129(b)(2)(A) of the Bankruptcy Code. Courts currently are divided on whether to use the "prime plus" formula adopted by the U.S. Supreme Court in the chapter 13 context in *Till v. SCS Credit Corp*., 541 U.S. 465 (2004), a market approach, the contract rate of interest, or some other calculation to determine the appropriate rate of interest in the chapter 11 cramdown context. The Supreme Court's prime plus formula basically considers "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."[10] After much study and deliberation, the Commission decided to recommend a market-based approach to calculate the cramdown rate of interest: "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."[11]

II. Notable Cases on Valuation

Although valuation is an important part of chapter 11 cases, valuation issues rarely are litigated to resolution. Rather, the costs to, and uncertainty of, the valuation process often encourage settlements. As the Commission noted, such negotiated resolutions align "with the consensual nature of the chapter 11 process."[12]

Nevertheless, some valuation disputes present novel or particularly complex issues that are difficult to settle. The resulting cases provide insights on judicial valuation and offer

[9] *See* FINAL REPORT, *supra* note 1, at 223.
[10] *Id.* at 235.
[11] *Id.* at 234.
[12] *Id.* at 182.

guidance to parties in future valuation disputes. The following summaries include a representative sampling of these cases.

Valuation Methodology. There are several well-tested and accepted methodologies for valuing firms and assets. These methods generally are grounded in an asset based, income based, or market based approach to valuation. The court in *In re Genco Shipping & Trading Ltd*., 513 B.R. 233 (Bankr. S.D.N.Y. 2014), provided a thoughtful overview of the most common valuation techniques:

> The first method, [discounted cash flow or] DCF, estimates the net present value of a company by:
>
> (i) projecting unlevered free cash flows over a given fixed forecast period, then discounting those cash flows back to the present using an estimated discount rate based upon the company's weighted average cost of capital ("WACC"); and
>
> (ii) deriving the value of all unlevered free cash flows beyond the explicit forecast period—the 'terminal value'—and then discounting that terminal value back to the present by applying the estimated discount rate. The enterprise value is determined by adding the numbers derived from (i) and (ii). … DCF analysis may be problematic where management's projections are inaccurate or unreliable. ...
>
> The second method, the market multiple or comparable company analysis, estimates the value of a company by using the value of comparable companies as an indicator of the subject company. … Values are standardized using one or more common variables such as revenue, earnings, or cash flow, with the expert then applying a multiple of the financial metric or metrics that yields the market's valuation of these comparable companies." … The key to this analysis is the choice of appropriate comparable companies relative to the company in question.
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> The third method, precedent transactions, looks at the purchase prices of comparable companies in recent transactions and uses the subject company's earnings, cash flow, or earnings before interest, taxes, depreciation, and amortization ("EBITDA") to determine a range of total enterprise value, or TEV. … "This method requires qualitative judgments in light of the unique circumstances of each precedent transaction and inherent differences between the precedent acquired companies and the subject company."…
>
> The Debtors maintain that a fourth methodology, net asset value ("NAV"), is the appropriate methodology to value a dry bulk shipping company. NAV is "based on independent appraisals that incorporate an impartial assessment of the broadest, most concrete consensus regarding future earnings." … NAV is a method that adds together the appraisal values and any other assets, such as ownership stakes in other companies, service contracts, and cash on hand. …

Genco, 513 B.R. at 242-244. A valuation professional may use multiple valuation methods to create a more accurate picture for the court and to test for variability in inputs. Under this

approach, the professional will assign each method a particular weight in the final calculation. Although professionals most frequently use DCF and the two market-based approaches described above (i.e., comparable companies and comparable transactions) in such a multi-method analysis, the weight accorded each method depends on the particular circumstances of the case and the judgment of the valuation professional. *See, e.g.,* Christopher S. Sontchi, *Valuation Methodologies: A Judge's View*, 20 AM. BANKR. INST. L. REV. 1, 214-215 (2012).

Selecting a Valuation Methodology. Not every valuation method works in every case. The court and the parties must consider, among other things, the debtor's business, industry, and asset base. The purpose and source of the valuation also are important. For example, a court may give more weight to a valuation based on the company's market capitalization than a valuation prepared by an expert for purposes of litigation.[13] The following cases discuss different approaches to valuation methodology in valuation disputes.

In *Genco*, the debtor was "one of the world's largest dry bulk shippers, operating with a fleet of 53 shipping vessels," and the valuation issue arose in the context of a fraudulent transfer action.[14] The court was presented with four different methods: DCF, comparable companies, comparable transactions, and NAV. The court analyzed the advantages and disadvantages to each approach, and it concluded that neither the DCF nor comparable transactions approach offered much utility in the particular case. The court found NAV to be the most useful valuation approach for dry bulk shippers, and it accorded NAV the greatest weight in the final calculation.[15]

An asset-based approach was rejected, however, by the court in *Whyte v. C/R Energy Coinvestment II, L.P. (In re SemCrude, L.P.),* 2013 WL 2490179, (Bankr. D. Del. June 10, 2013). The debtors in *SemCrude* operated primarily in the oil and gas industry, with some business in derivatives trading. The litigation trustee was pursing fraudulent transfer actions, and she based her insolvency analysis primarily on an asset-based (i.e., balance sheet) analysis. The trustee's expert identified several flaws in using DCF or market-based approaches in this particular case. Nevertheless, the court relied primarily on the defendants' DCF valuation, in part because the debtors were operating as a going concern at the time of the challenged transfers and both experts agreed that "the Income Approach is the preferred method to value a company on a going concern basis."[16]

Interestingly, the litigation trustee in *SemCrude* argued that DCF was of limited utility in the case because the debtors lacked reliable projections and financial data with which to perform

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[13] *See, e.g., VFB LLC v. Campbell Soup Co*., 482 F.3d 624, 632–33 (3d Cir. 2007).
[14] *See Genco*, 513 B.R. at 238 (the court also found the comparable companies approach useful in calculating the overall valuation).
[15] *See id.* at 244 ("[T]he Court concludes that NAV should not be the exclusive basis for valuation in this case, but nonetheless should be given substantial weight given the nature of the dry bulk shipping industry. The Court finds that a comparable companies analysis is equally useful in determining Debtors' value and that the precedent transaction analysis is of some limited utility. But the Court concludes that the DCF analysis is not an appropriate method of valuation, largely due to the highly speculative nature of rate projections for the dry bulk shipping industry.").
[16] *SemCrud*, 2013 WL 2490179, at *7.

the DCF valuation. The court in *SemCrude* rejected this position, but at least one court has found such an argument persuasive in the fraudulent transfer context. In *In re Adelphia Communications Corp*., 512 B.R. 447 (Bankr. S.D.N.Y. 2014), the court observed, "As a matter of common sense, DCF works best (and, arguably, only) when a company has accurate projections of future cash flows; when projections are not tainted by fraud; and when at least some of the cash flows are positive."[17] The court in *Adelphia* emphasized the importance of using more than one valuation method as a "sanity check," even if the valuation method was not perfectly suited for the particular case.[18] The court ultimately found significant flaws in each expert's valuation reports, and it reached an independent valuation based on the information provided by the experts. The district court affirmed the bankruptcy court's decision, and the parties have filed an appeal in the United States Court of Appeals for the Second Circuit.[19]

As noted above, courts place significant weight on the purpose of the valuation. In fact, in the context of a secured creditor's collateral, section 506(a) of the Bankruptcy Code specifically 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….."[20] In the plan confirmation context, the United States Court of Appeals for the Third Circuit has explained, "[T]he appropriate standard for valuing collateral must depend upon what is to be done with the property—whether it is to be liquidated, surrendered or retained by the debtor." *In re Heritage Highgate, Inc.,* 679 F.3d 132 (3d Cir. 2012). In *Heritage Highgate*, the court endorsed an income-based valuation of a residential development that the debtor proposed to retain and complete under the plan of reorganization.[21] In so holding, the court rejected both a hypothetical foreclosure approach, as well as a "wait and see" approach that would have considered potential proceeds from the sale of the development units at some point in the future. The relevant valuation was the fair market value of the collateral as of plan confirmation.

Subjectivity in Valuation. One of the challenges in any valuation dispute is the subjectivity inherent in a valuation determination. To be clear, the methods themselves are fairly standard and objective; however, the valuation professional has significant discretion in selecting inputs for each formula and assigning weights to each method in the final calculation. For example, in *In re Exide Technologies*, 607 F.3d 957 (3d Cir. 2010), both experts used a combination of DCF, comparable companies, and comparable transactions. Yet, their valuation ranges were substantially different, with one expert supporting an enterprise value of $950 million to $1.05 billion, and the other suggesting a range of $1.5 billion to $1.7 billion. The

[17] *Adelphia*, 512 B.R. at 471.
[18] *See id.* at 473-75.
[19] *In re Adelphia Communications Corp.,* No. 15-1015 (2d Cir. 2015).
[20] 11 U.S.C. § 506(a).
[21] The Third Circuit was guided by the Supreme Court's decision in *Associates Commercial Corp. v. Rash*, 520 U.S. 953 (1997) (endorsing use of replacement value for purposes of valuing collateral in chapter 13 cramdown context). *Heritage Highgate*, 679 F.3d at 141-142 ("Where a Chapter 11 plan of reorganization provides for a debtor to retain and use collateral to generate income with which to make payments to creditors, a § 506(a) valuation based upon a hypothetical foreclosure sale would not be appropriate, as it would be inconsistent with the provision's dictates. 'In ordinary circumstances the present value of the income stream would [instead] be equal to the collateral's fair market value.'") (citations omitted).

discrepancy related in large part to the weight accorded each valuation method and certain inputs used by the experts, such as the discount rate in the DCF calculation. The court ultimately adopted a valuation range of $1.4 billion to $1.6 billion.

Another example of subjective decisions undercutting the reasonableness of the expert's valuation report is found in *In re Iridium Operating LLC*, 373 B.R. 283 (2007). In *Iridium*, the creditors' committee was pursing an avoidance action against Motorola. The committee's experts either did not consider market-based methods or failed to adequately explain their decision to significantly discount a market-based approach. The court scrutinized the experts' DCF calculations, noting that the "DCF 'methodology has been subject to criticism for its flexibility; a skilled practitioner can come up with just about any value he wants.'"[22] The court found that the committee's experts' decisions to ignore market capitalization (or fail to reconcile their approaches with such valuation) discredited their valuation reports.

III. Issues for Consideration

As companies' capital structures become more complex and their asset bases shift from primarily identifiable tangible assets (such as that traditionally listed under plant, property, and equipment on the balance sheet) to more convoluted structures involving intangible assets, contract rights, and derivative products, valuation issues will only become more challenging in chapter 11 cases. The issues and cases discussed above will remain relevant, but they will not answer fully the valuation question. Moreover, cases involving multi-debtors or multi-secured creditors can complicate the analysis significantly.[23]

Courts and parties will need to consider carefully the kinds of businesses and assets at issue, as well as the purpose of the valuation, in selecting and applying valuation methods. The Commission's *Final Report* provides useful guidance in this endeavor. As noted in the *Final Report*, judicial valuation under the Bankruptcy Code provides the necessary flexibility for courts and parties to adapt valuation methods to the changing nature of chapter 11 debtors and cases. That flexibility, however, also likely means more uncertainty. Whether greater uncertainty will result in more valuation trials and guidance from the courts remains to be seen. Consequently, valuation issues will continue to be front and center in chapter 11 cases—whether they involve a section 363 sale or a traditional reorganization plan—as parties try to determine the best and most efficient use of the debtor's assets and the value available for distribution to creditors.

[22] *Iridium*, 373 B.R. at 351 (citations omitted).
[23] *See, e.g., In re Residential Capital, LLC*, 501 B.R. 549 (Bankr. S.D.N.Y. 2013) (aggregating the collateral of noteholders (rather than assessing on a debtor-by-debtor basis) for purposes of valuation to determine existence of any deficiency claim).

Appendix

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 prepetition 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.

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 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.

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).

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.

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 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

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 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.").

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 prepetition 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 prepetition 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 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.

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.

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 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

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.").

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 prepetition debt with the debtor's or the estate's postpetition 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 prepetition secured creditor's claim arising solely under section 507(b).

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 prepetition rights of secured creditors with the postpetition rehabilitative purposes of the Bankruptcy Code. If a debtor seeks to use cash collateral or prime a prepetition secured creditors' interests as part of, or pursuant to, a postpetition 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 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

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).

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 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]

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 postpetition 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.

The Commissioners discussed the kinds of prepetition 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 prepetition 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 prepetition bargain.[281] To that end, the Commission considered the various ways of providing secured creditors with the value of their prepetition bargain in the context of adequate protection.

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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).

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.").

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]

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.

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 postpetition, is not (or should not be) subject to a prepetition security interest. … [There is] support for this position under the Bankruptcy 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.

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 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 prepetition lender's position. The Commission ultimately decided that debtors in possession should be able to use cross-collateralization to provide adequate protection to prepetition 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 prepetition transfers that preferred certain unsecured creditors and reallocating the

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*.

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

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.

2. Terms of Postpetition Financing

Recommended Principles:

- A court should not approve any proposed postpetition financing under section 364 of the Bankruptcy Code that contains a provision to roll up prepetition debt into the postpetition facility or to pay down prepetition debt in part or in full with proceeds of the postpetition facility. This provision should not apply to postpetition financing, including a facility that refinances in part or in full prepetition debt, to the extent that —
    - o the postpetition facility (a) is provided by lenders who do not directly or indirectly through their affiliates hold prepetition debt affected by the facility or (b) repays the prepetition 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
    - o the court finds that the proposed postpetition financing is in the best interests of the estate.

- A court should not approve any proposed postpetition 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 Postpetition Financing Provisions*), a court should be able to approve, in a final order, permissible extraordinary financing provisions in connection with any proposed postpetition financing under section 364. For the definition of "permissible extraordinary financing provisions," see Section IV.C.1, *Timing of Approval of Certain Postpetition Financing Provisions.*

- Any prepetition contractual prohibition on subordinated prepetition junior secured creditors offering or providing postpetition financing to the debtor should not be enforced in the chapter 11 case, provided that: (i) any such subordinated prepetition junior secured creditors should not be permitted to prime the perfected security interests of the prepetition senior secured creditors with the postpetition financing

facility; and (ii) if the court approves the postpetition financing facility offered by the subordinated prepetition junior secured creditors, the prepetition 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 postpetition financing. These provisions would render unenforceable any contractual damages provisions that would otherwise allow prepetition senior secured creditors to recover damages for breach of contract against subordinated prepetition junior secured creditors under nonbankruptcy law based on the provision of postpetition financing. Sections 364 and 510 should be amended accordingly.

Terms of Postpetition 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, postpetition financing facility to achieve their postpetition objectives.[288] Section 364 of the Bankruptcy Code generally governs a debtor in possession's requests to obtain postpetition 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 postpetition 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 postpetition debt as a superpriority administrative claim, a secured claim in unencumbered property, a junior secured claim, or a senior secured claim (by priming prepetition 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 prepetition 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 prepetition secured lenders under the current standards for adequate protection, a debtor in possession often tries to negotiate a postpetition financing facility with its prepetition secured lenders. Such postpetition facilities may include cross-collateralization or roll-up provisions that provide additional protection to the prepetition lenders on their prepetition claims against the estate. Whether a court should approve cross-collateralization

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, *Postpetition 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).

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

Terms of Postpetition 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 postpetition 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 postpetition lenders and encourage the extension of credit to chapter 11 debtors. Some Commissioners suggested that lenders do not need additional incentives because postpetition financing has historically been not only safe, but also very profitable.[295] Other Commissioners challenged this assumption, noting the tightening of the postpetition credit market during the 2008 financial crisis.[296]

The Commission reviewed extensive materials on postpetition financing markets, terms, and impact, including a detailed report from the advisory committee and data compiled by the Loan

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., 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 postpetition 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 postpetition 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 Chemical Co.'s $8 billion Postpetition 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.

Syndications and Trading Association (the "***LSTA***").[297] The LSTA's data suggest that the majority of debtors that enter into postpetition 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 postpetition financing reorganized, whereas 52 percent of firms that did not have postpetition financing reorganized; (ii) 38 percent of firms without postpetition financing liquidated, whereas 23 percent of firms with postpetition financing liquidated; (iii) 16 percent of firms that had postpetition financing were eventually sold pursuant to a section 363 sale, whereas only 8 percent of firms that did not have postpetition financing were sold pursuant to a section 363 sale; and (iv) any relationship between postpetition 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 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 postpetition financing agreements include tighter covenants and milestones often designed to facilitate a loan-to-own

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 postpetition 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 postpetition 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 postpetition 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 postpetition 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 postpetition financing to use chapter 11 effectively. *Id. See generally supra* note 66 and accompanying text (generally discussing limitations of chapter 11 empirical studies).

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 postpetition 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").

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 postpetition financing terms.[302]

As a general matter, the Commissioners recognized the need for a robust, competitive postpetition financing market and the value it provides to distressed companies. They also appreciated the potential impact that any suggested reforms might have on that market; they aimed to encourage a competitive postpetition 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 postpetition 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 postpetition credit in a particular case.

To strike this balance, the Commissioners first evaluated the use of roll-up and cross-collateralization provisions in postpetition facilities. The Commissioners discussed the different kinds of roll-up provisions and their different justifications, specifically comparing provisions in postpetition facilities provided by a prepetition lender with provisions in postpetition 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 prepetition lender provides a postpetition

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 postpetition 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 postpetition 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 postpetition financing terms and their role in structuring and pricing the agreement; also addresses criticisms of such provisions), *available at* Commission website, *supra* note 55.

303 "When the debtor in possession's prepetition lender is acting as the postpetition 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 postpetition funds with the agreement that proceeds of prepetition accounts receivables will be applied to reduce the prepetition loan. Alternatively, a postpetition lender can simply lend enough postpetition to pay off the prepetition loan, whether owing to the postpetition lender or a different lender, immediately converting all of the lender's prepetition debt to postpetition debt. Postpetition 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.").

facility and the true "new credit" extended by such facility may be nominal (or nominal in relation to the amount of prepetition debt rolled up into the postpetition facility).[304] Although the Commission viewed a refinancing with a new lender differently, the Commission also noted the potential challenge in distinguishing among prepetition and postpetition lending groups. To assist in this task, the Commission methodically worked through the various scenarios in which one or more prepetition lenders may participate in a postpetition 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 prepetition lenders to improve their prepetition position through the use of cross-collateralization in postpetition 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 postpetition lenders a lien in its chapter 5 avoidance actions or the proceeds of such actions to secure the postpetition 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 postpetition financing under section 364 of the Bankruptcy Code. In the adequate protection context, section 507(b) of the Bankruptcy Code grants prepetition lenders a superpriority claim in situations when they have sought adequate protection, and adequate protection has failed. In contrast, a postpetition lender has other means to secure or protect its postpetition extension of credit to the debtor from the outset.

The Commissioners also evaluated the impact of provisions in a prepetition intercreditor or subordination agreement that precludes a prepetition junior secured lender from offering postpetition financing to the debtor without the consent of the senior secured lender. This kind of waiver by a junior lender in the prepetition intercreditor agreement can have a significant negative impact on the debtor in possession, who is often not a party to the agreement. Among

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 postpetition 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 postpetition 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).

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

other things, this waiver often removes an interested and viable source of financing from the debtor's pool of potential postpetition lenders, which may affect both the availability and terms of any postpetition 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 prepetition senior secured lenders. The Commissioners debated different ways to provide the debtor with the ability to discuss postpetition financing with junior lenders subject to this kind of waiver while still respecting the interests of the prepetition 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 postpetition financing to the debtor on two conditions: (i) the proposed facility does not prime the liens of the prepetition senior secured lender, and (ii) if the court approves the postpetition facility offered by such junior lenders, the prepetition senior secured lender has the right to step in and provide postpetition 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 postpetition 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 postpetition 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 postpetition 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,

306 The Commission's discussion of the use and approval of provisions in a postpetition 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 Postpetition 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*.

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 postpetition financing under section 364 in any interim order.
- In this context, "***permissible extraordinary financing provisions***" include: (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 postpetition lenders hold prepetition debt that would be affected by the postpetition facility, a provision that refinances prepetition debt with proceeds of the postpetition facility that is otherwise permissible under the principles relating to postpetition financing terms. *See* Section IV.B.2, *Terms of Postpetition 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*.

Timing of Approval of Certain Postpetition Financing Provisions: Background

Although an often necessary and critical source of postpetition liquidity, the postpetition facility negotiated between a debtor and its postpetition lenders may be subject to terms that could affect the chapter 11 case. For example, the terms of the proposed postpetition 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

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*.

552(b). The facility may also be subject to provisions addressing the validity of any prepetition 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 postpetition 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 postpetition 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.

Timing of Approval of Certain Postpetition Financing Provisions: Recommendations and Findings

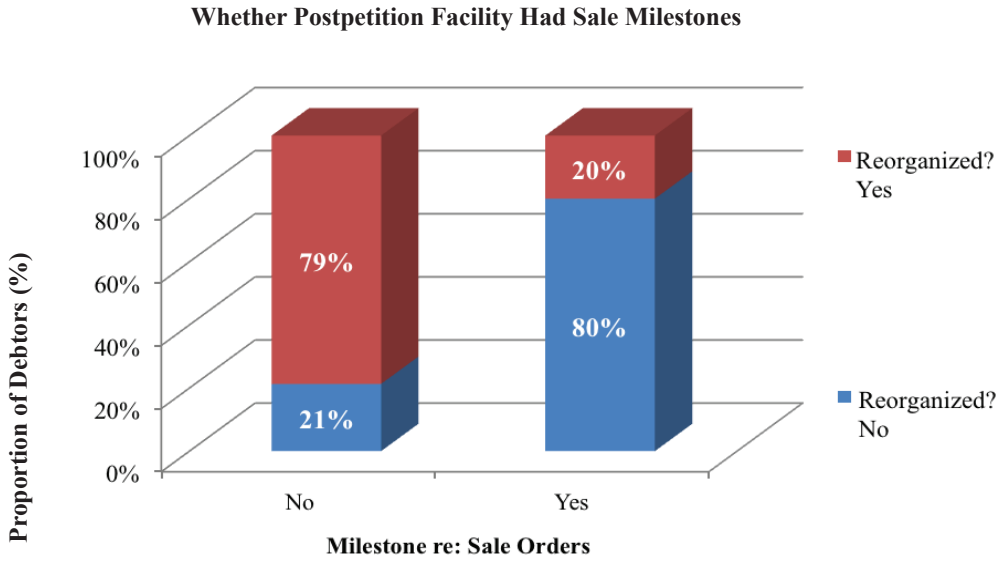
The Commissioners discussed at length the potential impact of terms in a postpetition credit agreement that dictate or attempt to influence the course of the chapter 11 case, or that implement waivers of, or otherwise affect, rights under the Bankruptcy Code.[309] The Commissioners identified a variety 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 postpetition financing documents; (ii) concessions regarding the validity or enforceability of prepetition 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 postpetition 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

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

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 postpetition 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 postpetition 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 postpetition 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*.

the Bidding Process for a 363 Sale."[311] A review of the 112 observations in the LSTA dataset with postpetition financing agreements (112 of 167 total sample) revealed that a postpetition facility subject to certain milestones or benchmarks in the chapter 11 case actually produced the required result — *i.e.*, postpetition credit agreements that required a section 363 sale resulted in a section 363 sale, and postpetition credit agreements that required the filing of a plan resulted in a confirmed plan.[312] Moreover, postpetition 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 Postpetition Facility

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.

312 Based on the LSTA dataset, if the postpetition 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.

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 such extraordinary provisions in postpetition facilities should be highlighted and clearly explained in the motion seeking approval of the postpetition 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.

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

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 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

auction process as a means to ensure that 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 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 postpetition marketing and

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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).

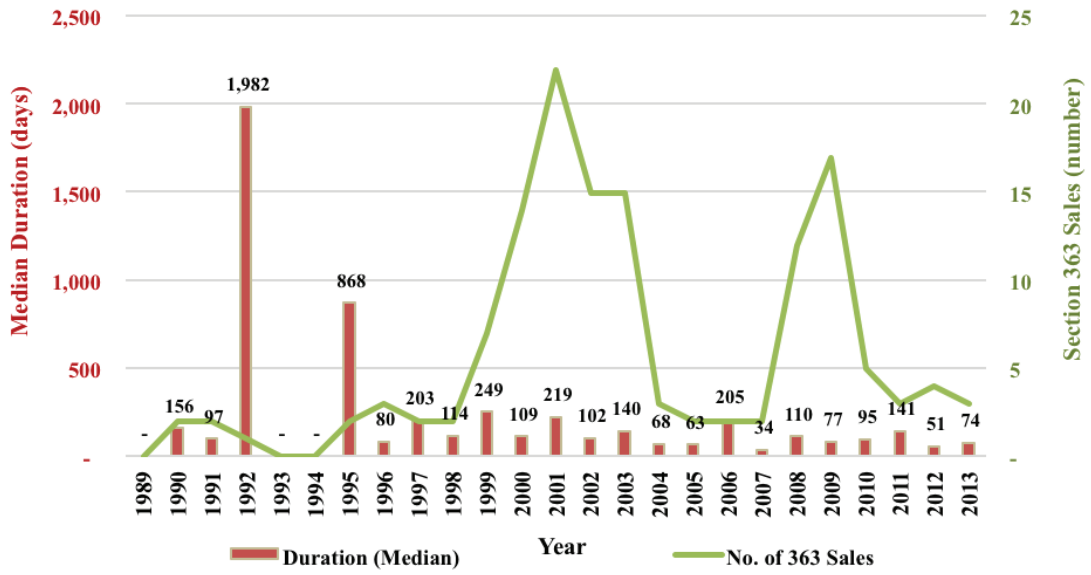
319 *See, e.g., In re* Fisker Auto. Holdings, Inc., 510 B.R. 55, 60–61 (Bankr. D. Del. 2014) ("It is the Court's view that Hybrid's rush to purchase and to persist in such effort is inconsistent with the notions of fairness in the bankruptcy process. The Fisker failure has damaged too many people, companies 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*.

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).

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]



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.

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.

Duration Between Bankruptcy Filing and Section 363 Sale Order							
Year	Mean No. of Days	Median No. of Days	No. of 363 Sales	Year	Mean No. of Days	Median No. of Days	No. of 363 Sales
1989	-	-		**2002**	287	102	15
1990	156	156	2	**2003**	227	140	15
1991	97	97	2	**2004**	72	68	3
1992	1,982	1,982	1	**2005**	63	63	2
1993	-	-	-	**2006**	205	205	2
1994	-	-	-	**2007**	34	34	2
1995	868	868	2	**2008**	187	110	12
1996	127	80	3	**2009**	81	77	17
1997	203	203	2	**2010**	134	95	5
1998	114	114	2	**2011**	116	141	3
1999	470	249	7	**2012**	63	51	4
2000	137	109	14	**2013**	82	74	3
2001	275	219	22				

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]

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

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

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 postpetition lenders and prepetition 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 prepetition claims 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 prepetition claims. Payments outside the chapter 11 plan may result in an unfair allocation of value among stakeholders in the chapter 11 case.

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.

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 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

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.

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 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

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.

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.

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 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

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.

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 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.
- 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.

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.

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.

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 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.

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. 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

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).
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).

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 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

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*.
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).

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 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.

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]

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 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

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 Collateral* 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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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 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 postpetition 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

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 postpetition financing to continue operations are creating increasing pressure to monetize the assets of the debtor's estate through quick section 363 sales.[787]

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

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 postpetition 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.

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).

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]

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

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 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 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*

ultimately concluded that 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-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

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 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.

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 the form of an actual option. The requirement is that the requisite *value* be distributed to the immediately junior class, regardless of form.

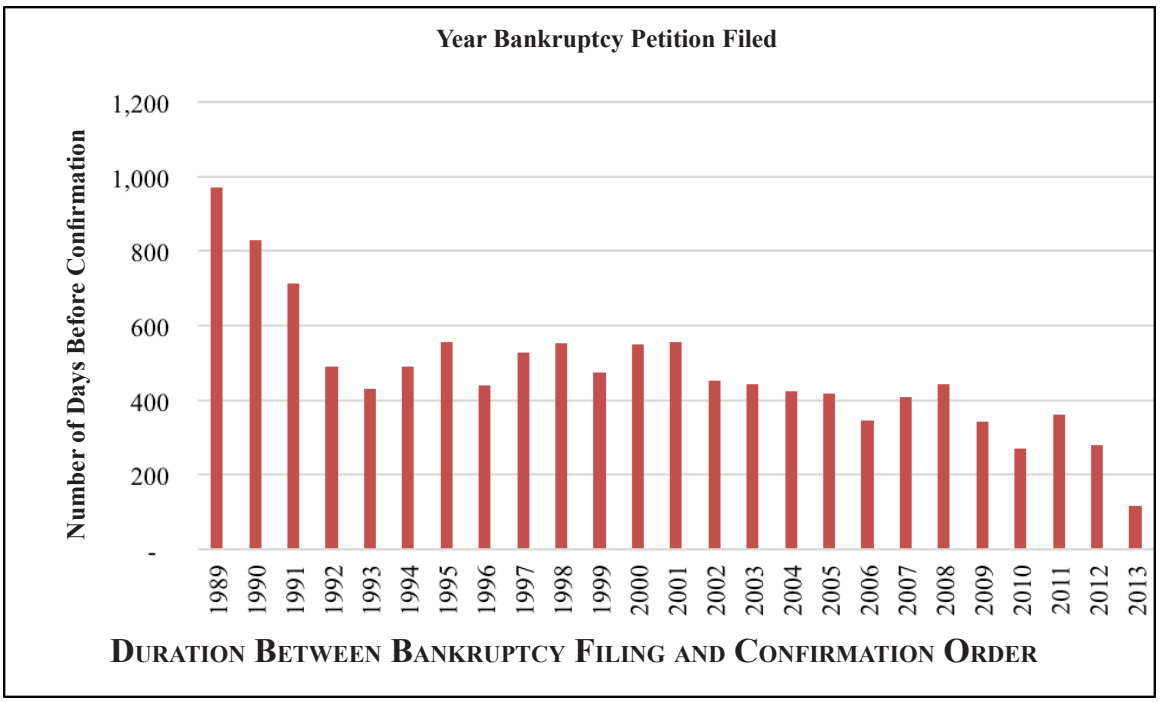
Although a relatively straightforward concept in a simple capital structure (see example below), the Commissioners recognized the potential complexities of applying these principles in more involved corporate and financing structures. Accordingly, the Commissioners strived to identify principles that 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]

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).



Duration Between Bankruptcy Filing and Confirmation Order

- *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 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

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.

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:

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

Recovery % on Senior Debt	Volatility 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 the potential challenges to

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 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).

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 prepetition 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.

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.

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 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.

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 for chapter 11 cases,[847]

844 Till v. SCS Credit Corp., 541 U.S. 465 (2004).
845 *Id.*
846 *Id.*
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

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.

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 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

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).

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:

- Senior creditors should not be permitted to make class-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.

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Legislative Update

BY DONALD S. BERNSTEIN AND JAMES E. MILLSTEIN

ABI Commission: Redemption Option Value Explained

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The ABI Commission to Study the Reform of Chapter 11[1] has recommended several important changes that affect the treatment of secured creditors in chapter 11 cases. This article summarizes some of the Commission's key proposals affecting secured creditor rights, including its proposal to modify the most fundamental of reorganization principles, the "fair and equitable" test contained in § 1129(b) of the Bankruptcy Code[2] (also known as the "absolute priority rule"), by requiring that junior stakeholders receive in a so-called "cramdown" scenario a minimum distribution at least equal to what the Commission calls the "redemption option value."

Focus: The Timing of Valuations in Reorganization Cases

Chapter 11 reorganization plans are now negotiated in the shadow of the absolute priority rule, under which the value of the enterprise at the time of distributions (the debtor's "reorganization value") dictates the entitlements of senior and junior stakeholders in accordance with their legal priorities.[3] Under the current law, the debtor's reorganization value typically becomes crystallized at one of two points in time: either when the firm's business is disposed of in a § 363 sale of substantially all the debtor's assets (a "§ 363x sale" in the Commission's Report), or at the confirmation hearing of a reorganization plan because a class of creditors has rejected the plan, forcing a valuation of the firm by the bankruptcy court to determine whether the plan can be confirmed under § 1129(b). Reorganization value can, however, fluctuate widely depending on when the valuation occurs, which can have a significant impact on the ultimate allocation of value among junior and senior classes. For this reason, the timing of the determination of reorganization value in chapter 11 cases, and how to mitigate its potentially arbitrary effect on distributional outcomes, was a major focus of the Commission.

The impact of valuation timing is especially important when modern capital structures are taken into account. It is increasingly common for a class or classes of pre-petition secured creditors to have a blanket lien on the debtor's assets, including the debtor's "property, plant and equipment," and its intangibles, inventory and receivables, and for the value of the secured claims to exceed the value of the firm at the time of the firm's failure. In such a context, since adequate protection cannot be provided, the secured creditors' consent is required for the debtor to obtain lien-priming debtor-in-possession financing and use cash collateral.

Due to their effective control over the debtor's liquidity, secured creditors can have significant influence over the timing of the determination of reorganization value in the case, using their ability to withhold consent to a financing, or the use of cash collateral to force a quick sale or acceleration of the plan process. The ability of secured creditors to control the timing of a sale or reorganization, together with their right to credit-bid if the collateral is sold, encourages strategic behavior by secured creditors to force the firm's value to be crystallized at a time when the firm's value is low so that they become entitled, under the absolute priority rule, to ownership of a greater fraction, or even the entirety, of the firm, including the right to any increase in the firm's value thereafter.

1 ABI Comm'n. to Study Reform of Chapter 11, Final Report and Recommendations (2014) (hereinafter, the "Commission Report"). The Commission Report is available for purchase at commission.abi.org.
2 11 U.S.C. § 1129(b).
3 *See* Douglas G. Baird and Donald S. Bernstein, "Absolute Priority, Valuation Uncertainty, and the Reorganization Bargain," 115 *Yale L.J.* 1930 (2006).

The Commission's concern over the ability of secured creditors to dictate the timing of valuation of the firm is reflected in a number of recommendations in the Commission's Report, including those regarding § 363x sales and adequate protection. The Commission recommended prohibiting § 363x sales during the first 60 days of a chapter 11 case (absent a showing of clear and convincing evidence that the debtor's value will be substantially impaired absent an earlier sale),[4] and recommended that the foreclosure value of a secured creditor's collateral, rather than a going-concern value, be used for purposes of determining adequate protection.[5] The latter recommendation reduces secured creditors' leverage to block post-petition financing or the use of cash collateral by withholding their consent. Both recommendations limit the leverage of secured creditors to accelerate the timing of value crystallization in the case.

However, the Commission also recognized that one of the principal purposes of a corporate reorganization is to preserve the firm's going-concern value for all stakeholders, including secured creditors. Accordingly, the Commission recommended that secured creditors receive credit for the full going-concern (reorganization) value of their collateral, both in determining their entitlements under a plan[6] and in determining their share of the proceeds of a § 363x sale.[7] The Commission also rejected the bankruptcy court's conclusion in the *Momentive* case to use of a submarket interest rate on take-back paper, recommending instead that a market rate of interest be used as opposed to a *Till* formula rate.[8]

The Commission struck a balance between reducing the leverage of secured creditors to truncate the chapter 11 process while preserving the fundamental priority rights of senior creditors under the absolute priority rule. These proposals would give the debtor greater flexibility to finance itself during the early stages of the case but, subject to the Commission's recommendation regarding "redemption option value," would recognize the rights of secured creditors to reap the benefits of a going-concern sale or reorganization.

Recommendation: Redemption Option Value

The Commission felt that if, by enforcing their rights through the collective chapter 11 process rather than under state law, secured creditors can benefit from any increase in the value of the firm realized by reorganizing a firm as a going concern under chapter 11 (as compared to liquidating their collateral in coordinated state foreclosure actions), as well as potential future increases in the value of the firm as a going concern, junior stakeholders should be fairly compensated for their residual interest in potential future increases in the value of the firm as well. Accordingly, the Commission concluded that the current absolute priority rule, which embraces a "single day of reckoning" — the plan's effective date — for determining reorganization value, should be modified to provide junior stakeholders with compensation equal to the value of this residual interest. If certain conditions are met, a junior class should be entitled to receive, at a minimum, a mandatory distribution reflecting what the Commission called the "redemption option value," even if a senior class votes against the plan and the senior claims are not being "paid in full" under the plan.

Under the Commission's proposal, redemption option value would be payable to a junior class or classes that, under the absolute priority rule (as currently applied), would otherwise receive little or no value. Consistent with a landowner's "equity of redemption" (the right to retain ownership of a mortgaged property by paying off a mortgagee prior to a foreclosure sale becoming final), the Commission determined that the class of creditors immediately junior to the class that would otherwise receive the residual value of the firm at the current valuation should be entitled to receive a distribution having a value equal to the value of a hypothetical option to purchase the entire firm at a strike price equal to the full entitlement of all senior classes.[9] The strike price of the hypothetical option would equal the full amount owed to the senior class or classes, including any unsecured deficiency claims, interest at the nondefault contract rate and unpaid fees and expenses, as accrued through the hypothetical exercise date of the option. The option's value would be determined by applying conventional option-pricing techniques, using the secured creditor's allowed claim as the option strike price, an option premium equal to the difference between the allowed secured claim and the firm's reorganization value under the plan, and an option term equal to the remaining time left between confirmation of the plan or consummation of a § 363x sale and the third anniversary of the petition date.

Under the proposal, the bankruptcy court could confirm a reorganization plan over the objection of an impaired senior class if the deviation from absolute priority treatment were limited to the distribution to the junior class of the redemption option value. The bankruptcy court could also cram down a plan that was rejected by a junior class if the plan provides that the junior class would receive at least redemption option value, calculated using the enterprise value proposed in good faith under the plan. In connection with a § 363x sale, the junior class would be entitled to redemption option value if the junior class does not object to the sale. When sale proceeds are distributed, the distributions to the senior class would be reduced accordingly.[10]

The Commission noted that the amount of time that debtors typically remain in chapter 11 is decreasing.[11] In 2013,

4 Commission Report at pp. 83-87.

5 *Id.* at pp. 67-73.

6 For debtors that reorganize, the reorganization value would be the enterprise value that is attributable to the reorganized entity (or the portion thereof attributable to the secured creditor's collateral). For debtors that sell all or substantially all of its assets, the reorganization value would be the net sale price for the enterprise. The right to going-concern value in connection with ultimate distributions in the case is subject to the entitlement of junior classes to redemption option value, as discussed below.

7 Though the Commission's recommendations would reduce a secured creditor's leverage to force an early § 363x sale by withholding consent to a financing or the use of cash collateral, when there is a "value differential," whether the trustee (or debtor in possession) sells the collateral in a § 363x sale or reorganizes, the secured creditor would be entitled to a secured claim based on the full sale or going-concern value of its collateral — not the foreclosure value. The right to the § 363x sale value is subject to any entitlement of junior classes to redemption option value, as discussed below.

8 *See Till v. SCS Credit Corp.*, 541 U.S. 465 (2004); *In re MPM Silicones LLC*, 2014 Bankr. LEXIS 3926 (Bankr. S.D.N.Y. Sept. 9, 2014).

9 For ease of discussion in this section, "junior class" refers to the class or classes of creditors junior to the class or classes that would otherwise receive the residual value of the reorganized firm. "Senior class" refers to the class or classes that would receive the residual value of the reorganized firm. The senior class would often be the fulcrum class of creditors, but not always.

10 However, in contrast to a reorganization, where the senior class retains most of the residual value of the firm, when the firm is sold to a third party for cash, the senior class retains no potential future upside counterbalance to this reduction. The Commission felt that the proposal should apply to both plans and § 363x sales in order to avoid pressure to sell the firm and to avoid the new rule. The secured class can submit a credit bid in connection with the sale if it wants to retain the upside potential of the firm.

11 Commission Report at p. 221.

debtors exited chapter 11 proceedings in fewer than 200 days on average, compared to close to 1,000 days in 1989. In the Commission's view, a chapter 11 process of less than 200 days likely does not afford enough time for depressed valuations caused by economic cycles, industry trends and other problems of a cyclical nature to normalize. As a result, at the time of plan confirmation or a sale of the firm, the firm may be undervalued and junior stakeholders may be undercompensated. Looking forward three years after the petition date allows a junior class to benefit from the firm's potential future value, rather than focusing on its value as of a single, arbitrary near-term date.

It is important to emphasize that the Commission's proposal would create a right to the *value* of a *hypothetical — not an actual — option*. That value could be provided to the junior class in any form: cash, debt, stock, warrants or other consideration, obviating the need for an actual buyout of the senior class to realize the value of the hypothetical option and eliminating the transaction costs and liquidity constraints associated with such a buyout right.

The effect of the proposed redemption option value entitlement for junior classes on distributions to senior classes will depend on the amount of the senior classes' claims, the firm's reorganization value, the volatility in the firm's valuation, and the length of time that the debtor has been in chapter 11 before a plan or sale is consummated. If a senior class is deeply impaired, the junior class redemption option value entitlement would have very little value.[12] Similarly, even if the senior class were almost "in the money," the redemption option value would still have little value if the plan or sale in question were ultimately consummated at or near the end of the three-year hypothetical option term.

Implementation: A Topic for Further Study

Creating an entitlement to redemption option value is intended to remove the fortuity of an arbitrary valuation date that often allows senior classes to be the exclusive beneficiaries of the continuation of the business as a going concern, cutting off the possibility that valuing the firm at a later date might have permitted senior classes to be paid in full and junior classes to be paid some residual value. The limited duration of the hypothetical option — to a date three years from the petition date — takes into account the typical half-life of business cycles and incentivizes out-of-the-money junior classes to eschew potentially harmful delaying tactics in order to maximize the redemption option value to which they are entitled.

While the proposal to create an entitlement to redemption option value represents a departure from the absolute priority rule as it is currently applied, the suggestion that junior classes should receive compensation for the option value implicit in their residual entitlement to the potential increases in the firm's value is not a new one,[13] and arguably reflects the way in which disputes over plan valuation and cramdown are often settled in the shadow of the absolute priority rule.[14] For this reason, the Commission believes that adopting the redemption option value proposal could reduce the range of possible disputes over chapter 11 plans, reducing costs and delays in chapter 11 cases. At the same time, the Commission acknowledges that the proposal may be difficult to implement in the context of complex capital structures, and recommends further study of how to make the proposal operational.[15] abi

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12 The Commission included an illustration of the calculation of redemption option value, showing the redemption option value at various levels of senior creditor recovery. *See* Commission Report at p. 222.

13 Anthony J. Casey, "The Creditor's Bargain and Option-Preservation Priority in Chapter 11," 78 *U. Chi. L. Rev.* 759 (2011); Lucian A. Bebchuk, "A New Approach to Corporate Reorganizations," 101 *Harvard L. Rev.* 775 (1988); Philippe Aghion, *et al.*, "The Economics of Bankruptcy Reform," 8 *J.L. Econ. & Org.* 523 (1992). For the classic treatment of relative priority as a distribution scheme in reorganization, *see* James C. Bonbright and Milton M. Bergerman, "Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization," 28 *Colum. L. Rev.* 127 (1928).

14 *See* Baird and Bernstein, fn.2.

15 *See* Commission Report at pp. 231-35.