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American Bankruptcy Institute

23rd Annual Bankruptcy Battleground West

"Confirmation Workshop: Summary of Issues and Cases Involved in the Liquidation Analysis Case Study"

Presented Tuesday, March 24, 2015

Hon. Barry Russell, Moderator
T. Scott Avilla
Edward T. Gavin
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American Bankruptcy Institute

22nd Annual Southwest Bankruptcy Conference

Confirmation Workshop

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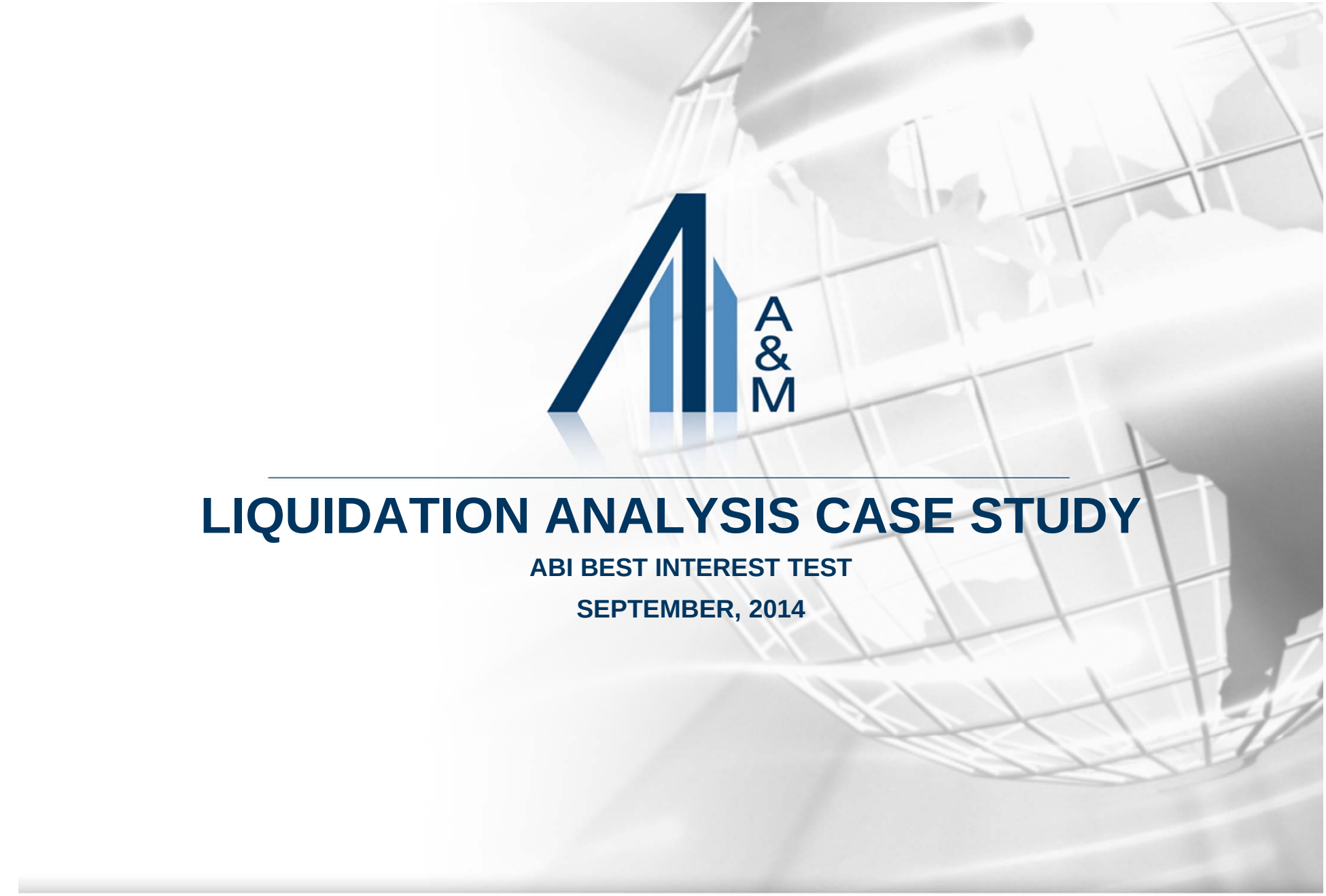

LIQUIDATION ANALYSIS CASE STUDY

ABI BEST INTEREST TEST

SEPTEMBER, 2014

EXECUTIVE SUMMARY

- A liquidation analysis is most often prepared when a company is in Chapter 11 as it is required to prove that a Plan of Reorganization ("POR") is in the best interest of creditors under bankruptcy code § 1129(a)(7)
  - The Best Interests Test is one of many requirements listed in Section 1129 that a plan proponent must satisfy
  - It establishes a "floor" with respect to the level of recovery to which all creditors and interest holders are entitled, pursuant to any confirmed plan of reorganization

- This section of the bankruptcy code requires that each holder of an impaired allowed claim or interest either:
  - Accept the plan of reorganization, or;
  - Is guaranteed that unless it otherwise agrees, will receive at least as much under the plan as it would in a liquidation of the Debtor in a Chapter 7 case

- The following case study is based upon the hypothetical liquidation of Overleveraged Inc. ("The Company") Overleveraged Inc. is a private equity roll-up in which the PE fund merged three steel / coal companies into one company using debt to finance the acquisition
  - The unsecured bonds claim the coal acquisition in 2012 was a fraudulent conveyance as $100 million of term debt was issued and the coal mine is worth substantially less (Unsecured notes believe the coal plant is not worth more than $60 million)

- Overleveraged Inc. has three primary businesses:
  - Coal mining
  - Steel production
  - Steel scrap and processing business

EXECUTIVE SUMMARY

- Capital structure
  - $50 million funded ABL due to Bank A
  - $250 million term loan due to a consortium of distressed debt funds
  - General unsecured debt including trade, pension and two unsecured notes – the 7% notes ($78 million) and the 10.375% notes ($52 million)

- The Debtors filed for chapter 11 10 months ago and have reached an agreement with their senior lenders. The plan of reorganization ("POR") proposes the following forms of consideration to emerge from chapter 11:
  - Coal mining – The coal mine is an unattractive asset and is contemplated to be sold at or following confirmation either by the Debtor or the liquidating trustee. Proceeds from the sale of the coal mine will fund recoveries to general unsecured creditors
  - Steel production and steel scrap business – both businesses have been sold for $280 million (coal mine in liquidation analysis for $42 million)

- Under the POR the senior lenders are contemplated to obtain a release for all potential causes of action.

- The unsecured 7% and 10.375% notes oppose the plan as they believe the senior lenders caused the company to have insufficient capital by issuing $100 million of term debt in order to purchase the coal mine

- The Debtors have prepared the following liquidation analysis which they believe meets the best interest of creditors under bankruptcy code § 1129(a)(7)

EXECUTIVE SUMMARY

- The plan releases all officers and directors of all claims relating to the operation of the business and all claims arising in connection with the negotiation of the plan

Commercial lease and Cause of Action

- The steel headquarters is a lease that has 18 years remaining on a 20 year lease
  - CEO was in the process of building his own “Taj Mahal” and at the time of the filing, walls were knocked down, construction equipment was everywhere and the building was uninhabitable
    - Buyer to reject lease at confirmation
    - CEO personally guaranteed the lease

- The landlord stumbles upon the renovation and has a heated argument with the CEO over the structural changes to the space and the fact that the rent is two months in arrears. In a rage, the CEO “head-butts” the landlord, who claims he had to seek medical attention.

BEST INTEREST TEST

Estimated % Recovery of Estimated Aggregate Amount of Allowed Claims

$'s in millions)

Low Scenario

	Proposed Plan of Liquidation		Chapter 7 Liquidation		Variance Better / (Worse)	
	%	$	%	$	%	$
Secured Claims	100.0%	$300	100.0%	$300	0.0%	$0
Ch 11 Admin Claims	100.0%	$59	100.0%	$59	0.0%	$0
Priority Claims	100.0%	$2	100.0%	$2	0.0%	$0
Unsecured Claims	5.0%	$25	0.0%	$0	***5.0%***	***$25***

High Scenario

	Proposed Plan of Liquidation		Chapter 7 Liquidation		Variance Better / (Worse)	
	%	$	%	$	%	$
Secured Claims	100.0%	$300	100.0%	$300	0.0%	$0
Ch 11 Admin Claims	100.0%	$59	100.0%	$59	0.0%	$0
Priority Claims	100.0%	$2	100.0%	$2	0.0%	$0
Unsecured Claims	20.0%	$101	13.7%	$69	***6.3%***	***$32***

- The Debtors believe the plan of reorganization meets the best interest test as all creditors are to receive more under the plan as compared to a hypothetical chapter 7

LIQUIDATION ANALYSIS – NET PROCEEDS

($'s in millions)		Balance Sheet	Recovery % Low	Recovery % Med	Recovery % High	Recovery $ Low	Recovery $ Med	Recovery $ High
Balance Sheet Assets to be Liquidated:								
Cash and Cash Equivalents	(a)	$1	100%	100%	100%	$ 1	$ 1	$ 1
Accounts Receivable, net	(b)	71	60%	70%	85%	43	50	60
Other Assets	(c)	42	5%	10%	19%	2	4	8
Inventory								-
Raw	(d)	22	1%	5%	10%	0	1	2
WIP	(d)	38	10%	15%	25%	4	6	10
Finished	(d)	49	30%	40%	50%	15	20	25
PP&E Net	(e)	65	0%	5%	8%	0	3	5
Intangible Assets	(f)	291	0%	10%	15%	-	30	44
Deferred Payments	(g)	50	0%	0%	0%	-	-	-
Other Long Term Assets	(h)	2	0%	0%	0%	-	-	-
		$631				$ 65	$ 115	$ 154
Asset Sales	(i)	284				322	322	322
Total Gross Proceeds from Liquidation						$ 387	$ 436	$ 476
Chapter 7 Estimated Costs								
Chapter 7 Trustee Fees	(j)		1.8%	2.0%	2.5%	$ 7	$ 9	$ 12
Chapter 7 Banker / Broker Fees for Asset Sales	(k)		5.0%	5.0%	5.0%	16	16	16
Wind-down Costs	(l)		12	15	18	12	15	18
						$ 35	$ 40	$ 46
Net Proceeds Available after Chapter 7 Estimated Costs						$ 352	$ 397	$ 430

LIQUIDATION ANALYSIS - WATERFALL

($'s in millions)		Balance Sheet	Recovery % Low	Recovery % Med	Recovery % High	Recovery $ Low	Recovery $ Med	Recovery $ High
Net Proceeds Available after Chapter 7 Estimated Costs						$ 352	$ 397	$ 430
Net Estimated Proceeds Available for Distribution to Secured Claims						$ 352	$ 397	$ 430
Senior Lender Claims								
Revolver / Term Loan / Accrued Interest	(m)	$ 300				$ 300	$ 300	$ 300
		$ 300				$ 300	$ 300	$ 300
				Net Estimated Recovery		*100.0%*	*100.0%*	*100.0%*
Chapter 11 Administrative Claims								
AP & Accrued Operating Expenses	(n)	$ 47				$ 47	$ 47	$ 47
Professional Fees	(n)	12				12	12	12
		$ 59				**$ 59**	**$ 59**	**$ 59**
				Net Estimated Recovery		*87.6%*	*100.0%*	*100.0%*
Priority Claims	(o)	$ 2				**$ 2**	**$ 2**	**$ 2**
Net Est. Proceeds Available for Distribution to Unsecured Claims						**-**	**36**	**69**
General Unsecured Claims								
Accounts Payable	(p)	$ 127				$ 127	$ 127	$ 127
Accrued Expenses	(p)	99				99	99	99
Non Priority Taxes	(p)	42				42	42	42
Long Term Debt- 7% note	(p)	78				78	78	78
Long Term Debt- 10.375% Note	(p)	52				52	52	52
Other Notes	(p)	10				10	10	10
Environmental Claims	(p)	36				36	36	36
Retirement Accts / Pension	(p)	19				19	19	19
Other Liabilities	(p)	45				45	45	45
Steel HQ Lease Rejection Claim	(q)	TBD				TBD	TBD	TBD
Head Butt Tort	(q)	TBD				TBD	TBD	TBD
		$ 507				**$ 507**	**$ 507**	**$ 507**
				Net Estimated Recovery		*0.0%*	*7.0%*	*13.7%*

NOTES TO LIQUIDATION ANALYSIS - ASSETS

a) **Cash:** Recovery is typically 100%, but it is important to understand if cash is restricted or held at multiple entities. Cash on hand is typically used by the Trustee to manage the early stages of a liquidation

b) **Accounts Receivable, net**: customer set-off rights are important to understand when valuing AR

c) **Other Assets:** Include: investments, tax assets, pre-paid rent, etc.

d) **Inventory:** Inventory types including raw materials, WIP, and finished goods have different recovery rates depending on type, age and industry

e) **PP&E, net:** Determined using appraisal factors (NOLV) that may be less than book value; land, buildings, machinery, tooling, etc.

f) **Intangible Assets:** Includes, patents, copyrights, trademarks and software

g) **Deferred Payments:** Relate to deferred debt financing fees, assumes zero recovery

h) **Other Long Term Assets:** Assumes various investment in subsidiaries

i) **Asset Sales:** The chapter 7 trustee is assumed to sell two subsidiaries as a going concern to maximize proceeds

NOTES TO LIQUIDATION ANALYSIS - ASSETS

j) **Chapter 7 Trustee Fees:** The U.S. trustee receives fees based on gross proceeds generated by the estate. **The chapter 7 trustee fees are calculated based on cash received from sales during the chapter 11 process**

k) **Chapter 7 Banker / Broker Fees for Asset Sales:** Assumes the Chapter 7 Trustee will retain financial advisors, legal counsel and investment bankers to assist during the liquidation process

l) **Wind-down Costs:** Administrative costs incurred during the wind-down of operations and the sale of assets. These costs include salaries, severance, retention, facility rent, and others

m) **Revolver / Term Loan / Accrued Interest:** Includes $50 million ABL and $250 million secured term loan all secured by substantially all of the Debtors' assets

n) **AP & Accrued Operating Expenses / Professional Fees:** Unpaid chapter 11 administrative claims including professional fees and operating expenses

o) **Priority Claims:** Includes claims for goods received 20 days prior to filing per section 503(b)(9) of the bankruptcy code

p) **General Unsecured Claims:** Analysis assumes unsecured claims include (among others): trade payables, unsecured debt (i.e. bonds), unsecured intercompany loans, accrued employee benefits

q) **Steel HQ Lease Rejection Claim & Head Butt Tort** – See executive summary for details

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Summary of Issues and Cases Involved in the Liquidation Analysis Case Study

ISSUE 1: Best Interest Test at Plan Confirmation, Generally

- *In re Stone & Webster, Inc.*, 286 B.R. 532 (Bankr. D. Del. 2002)
    - "[A] plan may not be confirmed unless it meets the 'best interests test' of section 1129(a)(7) of the Bankruptcy Code, which requires that creditors receive at least the same as they would receive in a chapter 7 liquidation." *Id.* at 544.
    - "The application of the best interest test involves a hypothetical application of chapter 7 to a chapter 11 plan. A liquidation and distribution analysis is performed to see whether each holder of a claim or interest in each impaired class, as such classes are defined in the subject plan, receive not less than the holders would receive in a 'hypothetical Chapter 7 distribution' to those classes." *Id.*at 544-45 (citing 7 *Collier on Bankruptcy* ¶ 1129.03[7][b], p. 1129-43 (15th ed. rev. 2002)).
    - "Section 1129(a)(7) 'is an individual guaranty to each creditor or interest holder that it will receive at least as much in *reorganization* as it would in *liquidation*.'" *Id.* at 545 (quoting 7 *Collier on Bankruptcy* ¶ 1129.03[7][b], p. 1129-43 (15th ed. rev. 2002) (emphasis in case, not in *Collier*)).
- *Cadle Co. II, Inc. v. PC Liquidation Corp. (In re PC Liquidation Corp.)*, 383 B.R. 856 (E.D.N.Y. 2008)
    - "Section 1129(a)(7) provides, in relevant part, that the bankruptcy court 'shall confirm a plan only if . . . [w]ith respect to each impaired class of claims or interests—(A) each holder of a claim or interest of such class—(i) has accepted the plan; or (ii) will receive or retain under the plan on account of such claim or interest property of a value, as of the effective date of the plan, that is *not less than* the amount that such holder would so receive or retain if the debtor were liquidated under chapter 7 of this title on such date.'" *Id.* at 868 (quoting 11 U.S.C. § 1129(a)(7)).
    - "The Second Circuit has held that Section 1129(a)(7) 'incorporates the former 'best interest of creditors' test and requires a finding that each holder of a claim or interest either has accepted the plan or has received no less under the plan than what he would have received in a Chapter 7 liquidation.'" *Id.* (quoting *Kane v. Johns-Manville Corp.*, 843 F.2d 636, 649 (2d Cir. 1988)).
    - "'In determining whether the best interests standard is met, the court must measure what is to be received by rejecting creditors in the impaired classes under the plan against what would be received by them in the event of liquidation under

chapter 7.'" *Id.* (quoting *In re Adelphia Commc'ns Corp.*, 368 B.R. 140, 252 (Bankr. S.D.N.Y. 2007)).

- "'In order to show that a payment under a plan is equal to the value that the creditor would receive if the debtor were liquidated, there must be a liquidation analysis of some type that is based upon evidence and not mere assumptions or assertions. . . . However, the valuation of a hypothetical chapter 7 liquidation is, by nature, inherently speculative and is often replete with assumptions and judgments.'" *Id.* (quoting *In re Adelphia Commc'ns Corp.*, 361 B.R. 337, 366-67 (S.D.N.Y. 2007)).

- The proponent of a plan bears the burden of showing that the plan complies with Bankruptcy Code section 1129(a)(7). *Id.* at 869 (citing *Adelphia*, 361 B.R. at 364).

ISSUE 2: *Quigley* – Best Interest Test Not Satisfied Where Plan Releases Third Party Claim That Would Have Been Retained By Creditor In Chapter 7

- *In re Quigley Co., Inc.*, 437 B.R. 102, 145-46 (Bankr. S.D.N.Y. 2010)

  - Holding: proposed plan failed best interest of creditors test (section 1129(a)(7)) for plan confirmation where chapter 11 plan would release Pfizer from derivative liability. In a hypothetical chapter 7 case, creditors would "retain their rights to pursue non-debtors for full payment. . . ." *Id.* at 145. Under the proposed plan, the dissenting creditors would "receive an estimated 7.5% distribution on their allowed claims." *Id.* at 146. The court estimated that derivative claims against Pfizer – to be released under the proposed plan – were worth approximately 23% of the creditors' allowed claims. *Id.* Because section 1129(a)(7) provides that each impaired claims of claims or interests will "receive or ***retain***" as much under a chapter 11 plan as they would under chapter 7, "giving at least liquidation value to each creditor requires protection of the Chapter 7 right to pursue non-debtor actions." *Id.* at 145.

  - *But see In re Dow Corning Corp.*, 237 B.R. 380, 411 (Bankr. E.D. Mich. 1999) ("A best-interests-of-creditors test that is almost identical to the one found in § 1129(a)(7) is contained in § 1325(a)(4). Courts construing this chapter 13 provision uniformly hold that amounts obtainable from other sources, such as guarantors, are irrelevant when performing that section's best-interest-of-creditors test.").

  - Note: the *Quigley* court found that the cases analyzing 1325 were distinguishable because that section "does not include the 'retention' language in § 1129(a)(7)." 437 B.R. at 146.

ISSUE 3: *Ivanhoe* Rule

- ***Creditor May Assert Claim In Full Amount Even Where Creditor Has Received or May Receive Partial or Full Payment From Third Party***

    - *Ivanhoe Bldg. & Loan Ass'n v. Orr*, 295 U.S. 243, 55 S.Ct. 685, 79 L.Ed. 1419 (1935)

        - Creditor may assert claim against debtor in full face amount without reducing claim to account for amounts recovered or recoverable from non-debtor parties.

        - However, creditor "may not collect or retain dividends which with the sum realized from the foreclosure will more than make up that amount."

    - *Reconstruction Fin. Corp. v. Denver & Rio Grande W. R.R. Co.*, 328 U.S. 495, 529, 66 S.Ct. 1384, 90 L.Ed. 1400 (1946)

        - "[I]n bankruptcy proceedings . . . a creditor secured by the property of others need not deduct the value of that collateral or its proceeds in proving his debt."

    - *Nuveen Mun. Trust v. Withumsmith Brown, P.C.*, 692 F.3d 283 (3d Cir. 2012)

        - Under *Ivanhoe*, "a creditor may file a proof of claim for the total amount it is owed by a debtor even if it has recovered or may recover all or a portion of that amount from a non-debtor." *Id.* at 295.

        - However, "a creditor cannot *collect* more, in total, than the amount it is owed." *Id.* (emphasis added).

    - *In re Nat'l Energy & Gas Transmission, Inc.*, 492 F.3d 297, 301 (4th Cir. 2007)

        - "In *Ivanhoe*, the Supreme Court held that a creditor need not deduct from his claim in bankruptcy an amount received from a non-debtor third party in partial satisfaction of an obligation."

    - *In re Del Biaggio, III*, 496 B.R. 600 (Bankr. N.D. Cal. 2012)

        - Issue: whether creditor who obtains partial recovery from a non-debtor co-obligor is required to reduce claim against debtor?

        - Argument: *Ivanhoe* is inapplicable because state law governs existence and amount of claims and CA law requires that creditor's claim be reduced by amounts recovered from co-obligors (the "Reduction-of-Claim Approach")

- Holding: "the Reduction-of-Claim Approach utilized by California courts outside of bankruptcy does not require this court to depart from the Limitation-on-Dividend Approach adopted in *Ivanhoe* for use in bankruptcy cases." *Id.* at 603.

    - "*Ivanhoe* decides that the amount [of] the creditor's claim in the bankruptcy case is not affected by third-party payments, except to the extent payment from the debtor would produce a double recovery." *Id.*

- *In re Journal Register Co.*, 407 B.R. 520, 533 (Bankr. S.D.N.Y. 2009)

    - "We start with the proposition that members of an unsecured creditor class may have rights to payment from third parties, such as joint obligors, sureties and guarantors, and these rights may entitle them to a disproportionate recovery compared to other creditors of the same class (up to a full recovery)."

- *In re F.W.D.C., Inc.*, 158 B.R. 523, 527-28 (Bankr. S.D. Fla. 1993)

    - Claim against "debtor-guarantor … need not be reduced to reflect the creditor's receipt of a third party's … collateral securing the third party's indebtedness guaranteed by the debtor." *Id.* at 527.

    - Movants argued that the line of cases/*Ivanhoe* rule is no longer applicable/controlling because:

        - Decided under the Act, based upon the Act's narrow definition of "secured creditor"

        - Bankruptcy Code focuses on secured "claims" rather than secured "creditors"

        - Act sections upon which *Ivanhoe* relief have been displaced by section 506(a) which requires that the claim be reduced. *Id.*

    - Holding: line of case law is still applicable and controlling; creditor permitted to prove a claim for the full amount of the indebtedness without deducting value of collateral received. *Id. at 528.*

        - However, "creditor may not collect more than the total amount of the indebtedness." *Id.*

- ***Creditor's Claim Must be Reduced To Account for Value Of Collateral Received Via Foreclosure***

    - *In re Anson*, 457 B.R. 130 (Bankr. M.D. Fla. 2011)

        - Holding: creditor's claim must be facially reduced to account for value of collateral which the creditor has acquired via foreclosure against third party

    - *In re Johnson*, 477 B.R. 879, 881-82 (Bankr. M.D. Fla. 2012)

        - Holding: recognizing ruling in *Anson* that creditor's claim must be reduced by the value of foreclosed property, but ultimately adopting *Ivanhoe* rule.

        - Court acknowledged the line of cases which do "not require a creditor's claim to be reduced to reflect the value of the acquired collateral" and which permit creditors to "file proofs of claim for the full amount of indebtedness." *Id.* at 882 (citing *Ivanhoe* and others).

        - According to the court, both line of cases essentially hold that "no more than a full recovery of the indebtedness may be had[,]" but differ as to the approach in reaching that result. *Id.*

        - "Under the *Anson* approach [cited below], the Court would reduce the facial proof of claim amount, while the [*Ivanhoe*] approach would allow a proof of claim to be filed, on its face, for the full amount, with the caveat that any distribution made within the bankruptcy proceeding could not exceed the total indebtedness." *Id.* at 882-83.

        - According to the court, limiting the face amount of the claim was appropriate in *Anson* because there the debtors proposed to pay unsecured creditors 100% of their allowed unsecured claims and "the creditor would have obtained a double recovery vis-à-vis the proposed plan treatment. Therefore, out of necessity, the court had to reduce the claim on its face." *Id.* at 883.

        - In adopting the *Ivanhoe* rule, the court "does not mean to imply that *Anson* is not good law, or that *Anson* should not be followed in appropriate circumstances." *Id.* at 883 n.6.

    - *In re Quigley Co., Inc.*, 346 B.R. 647, 656-58 (Bankr. S.D.N.Y. 2006)

        - Holding: settling claimants' concession of 90% of their claims under third party settlement should be considered in estimating the value of the claimants' claims for voting purposes. *Id.* at 657-58.

- While court does not specifically discuss or address the *Ivanhoe* rule, it recognizes that each creditor is entitled to vote its total "allowed" claim under section 1126(c). Nonetheless, the court held that vote dilution consistent with the third party settlement was necessary to "ensure voting power that is commensurate with the [settling claimants'] economic interests and the economic realities of the case." *Id.*

- Court noted that, had the claims been liquidated at the settlement amount, they would have only been "allowed" at that reduced amount, so the result is consistent with section 1126(c). *Id.* at 658.

ISSUE 4: Trustee's Commissions/Fees Under Bankruptcy Code §§ 326 and 330

- ***Courts Have Discretion To Award Compensation In Amounts Less Than Cap***

  - *In re Luedtke*, No. 07-70924, 2011 WL 806003 (Bankr. C.D. Ill. Feb. 28, 2011)

    - "[S]ome chapter 7 trustees . . . [have] argue[d] that the maximum percentage commissions set forth in § 326 are now the fixed percentages which should be routinely allowed in virtually every case." *Id.* at *3.

    - "Courts having considered such arguments have, however, universally rejected them and have consistently held that Chapter 7 trustee compensation remains subject to court review for reasonableness." *Id.* (citing *In re Clemens*, 349 B.R. 725 (Bankr. D. Utah 2006); *In re Ward*, 366 B.R. 470 (Bankr. W. D. Pa. 2007); *In re Mack Props., Inc.*, 381 B.R. 793 (Bankr M.D. Fla. 2007); *In re McKinney*, 383 B.R. 490 (Bankr. N.D. Cal. 2008); *In re Phillips*, 392 B.R. 378 (Bankr. N.D. Ill. 2008); *In re B & B Autotransfusion Servs., Inc.*, 443 B.R. 543 (Bankr. D. Idaho 2011)).

    - Holding: "the calculation [of a chapter 7 trustee's commission] is not firmly fixed by the maximum percentages set forth in § 326 but remains a subjective determination based on reasonableness." *Id.*

    - Section 330(a) "compel[s] a court to consider what trustee services were actually provided." *Id.*

    - The maximum allowable commission amounts set forth in section 326 "may be reduced to avoid awards which are disproportionate to the actual services rendered." *Id.*

    - Chapter 7 trustee has burden to prove entitlement to requested fees. *Id.* at *4.

    - Factors:

      - Some courts have held that *Johnson* factors still apply. *Id.* at *4 (citing *Clemens*, 349 B.R. at 732; *Phillips*, 392 B.R. at 385).

- Other courts look to "time records, the statutory commission formula in § 326, and all 'other relevant factors' . . . ." *Id.* (citing *McKinney*, 383 B.R. at 493).

- After considering factors, court **reduced fee** from maximum because "statutory maximum . . . bears little relationship to reasonable compensation for the services *actually* rendered . . . ." *Id.* (emphasis added). $1.3 million "was handed to the trustee" so "a significant portion of the funds he will be distributing required no work on his part to collect."

- *B & B Autotransfusion Servs., Inc.*, 443 B.R. 543 (Bankr. D. Idaho 2011)

  - "Knowing what a trustee *did* in a case—that is to say an itemization of the services rendered—is essential. Without that information, the Court cannot perform its required role under § 326(a) (*i.e.*, determining 'reasonableness'), § 330(a)(1)(A) (*i.e.*, determining 'reasonable compensation for the *actual*, necessary services rendered by the trustee, and § 330(a)(4) (*i.e.*, determining if there was unnecessary duplication of services or services rendered that were not reasonably likely to benefit the estate or necessary to administration)." *Id.* at 551.

  - Factors to be considered include:

    - Amount of compensation based on the 326 maximum;

    - Functions performed by trustee;

    - Risk of nonpayment;

    - Involvement/assistance of other professionals;

    - Time expended.

  - "[T]his case presents a situation where a very large asset was disclosed, realized upon and reduced to cash, and is now ready for final distribution to creditors. Trustee's services, though competent, were limited . . . [and therefore the] maximum § 326(a) commission is . . . quite high in relation to the services performed." *Id.* at 554.

  - "[T]here may be cases where the amount of 'money disbursed' by the trustee may be very high in relation to the services performed, presenting a risk that a trustee may be overcompensated by applying the . . . commission percentage. . . . In such cases, even if all the services were properly performed, courts will need to assess whether the implied hourly rate is so high as to render the fee not reasonable." *Id.* (quoting *Collier*, ¶ 330.02[1][a], at 330-9 to 330-10).

- ***Trustee is Per Se Entitled to Cap Absent Extraordinary Circumstances***

    - *In re Rowe*, 750 F.3d 392 (4th Cir. 2014)

        - Issue: whether, under BAPCPA, "a bankruptcy court is required, absent extraordinary circumstances, to compensate Chapter 7 trustees on a commission basis." *Id.* at 393.

        - "Thus far, no circuit court of appeals has confronted this issue, and the lower courts are deeply divided." *Id.* (citing cases).

        - Holding: "absent extraordinary circumstances, Chapter 7 trustees must be paid on a commission basis, as required by 11 U.S.C. § 330(a)(7)." *Id.* at 394.

        - After BAPCPA, "330(a)(3) is generally immaterial in determining the compensation for a Chapter 7 trustee . . . ." *Id.* at 396.

        - Section 330(a)(7) provides that "[i]n determining the amount of reasonable compensation to be awarded to a trustee, the court *shall* treat such compensation as a commission, based on section 326." *Id.* (emphasis added).

        - By choosing to use the mandatory term "shall" in 330(a)(7), it made "its application in the determination of Chapter 7 trustee fee awards mandatory." *Id.* at 397.

        - What extraordinary circumstances might allow section 326(a) commission rates to be reduced?

            - Not performing trustee duties; or

            - Performing them negligently or inadequately. *Id.*

    - *In re Eidson*, 481 B.R. 380 (Bankr. E.D. Va. 2012)

        - "The purpose of the amendment to Section 330(a)(3), and the addition of Section 330(a)(7) to the Code in 2005, was to clarify Congress's intent that the Trustee's compensation is, unlike professional fees, to be commission-based, absent extraordinary circumstances." *Id.* at 384.

        - While there is still a reasonableness requirement under Sections 326(a) and 330(a)(7), "absent extraordinary circumstances, this reasonableness requirement should be viewed primarily in terms of results achieved (i.e., a commission-based compensation), rather than the traditional *Johnson*-type factors." *Id.*

- *Hopkins v. Asset Acceptance LLC (In re Salgado-Nava)*, 473 B.R. 911 (9th B.A.P. 2012)

    - "[A]bsent extraordinary circumstances, chapter 7, 12 and 13 trustee fees should be presumed reasonable if they are requested at the statutory rate." *Id.* at 921.

    - "Congress would not have set commission rates for bankruptcy trustees in §§ 326 and 330(a)(7), and taken them out of considerations set forth in § 330(a)(3), unless it considered them reasonable in most instances."

    - If extraordinary circumstances exist, court may consider the 330(a)(3) factors and a lodestar analysis. *Id.*

ISSUE 5: Valuation Issues

- ***Valuation Issue In Connection With Plan Confirmation, Generally***

    - Valuation of assets (or of the debtor's business as a whole) in a chapter 11 case depends in large part upon whether the assets/business will be used as a going concern or sold/liquidated. *In re Heritage Highgate, Inc.*, 679 F.3d 132, 141 (3d Cir. 2012) ("the 'proposed disposition or use' of the collateral is of paramount important to the valuation question.").

    - Depending upon proposed use, assets may have a "going concern" value or a "liquidation value"

    - Going concern values are, as a general matter, higher than liquidation values

    - Valuation is flexible, and bankruptcy courts have broad discretion to determine which standard "best fits the circumstances of the particular case." *Heritage Highgate, Inc.*, 679 F.3d at 141.

        - Valuation fights will often turn into a battle of the experts

    - If the debtor intends to continue to use the particular asset in its ongoing business, courts have held that the proper value of the asset is its "fair market value" which reflects "the price a willing buyer in the debtor's trade, business, or situation would pay a willing seller to obtain property of like age and condition." *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 959 n.2, 117 S.Ct. 1879, 138 L.Ed.2d 148 (1997).

        - While there are a variety of methodologies used to determine the value of a debtor's assets, four generally accepted approaches have emerged:

            - Market Comparison Approach (examines the value the market assigns to a debtor or an asset);

- Comparable Transaction Approach (identifies recent transaction of comparable peer company and scales the price to identify value of the debtor);

- Comparable Companies Approach (derives value from the value of the debtor relative to the value of peer companies); and

- Discounted Cash Flow Approach (calculates future cash flow and discounts it by the projected weighted cost of capital).

- *See Credit Agricole Corporate & Inv. Bank N.Y. Branch v. Am. Home Mortg. Holdings, Inc. (In re Am. Home Mortg. Holdings, Inc.)*, 637 F.3d 246, 258 (3d Cir. 2011) (discounted cash flow analysis is reasonable determinant of value); *In re Tribune Co.*, 464 B.R. 126, 149-51 (Bankr. D. Del. 2011) (analyzing valuation of debtor using discounted cash flow and comparable companies methodologies); *In re Chemtura Corp.*, 439 B.R. 561, 572-90 (Bankr. S.D.N.Y. 2010) (evaluating discounted cash flow, comparable companies and precedent transaction valuation methodologies); *In re Am. Home Patient, Inc.*, 298 B.R. 152, 174 (Bankr. M.D. Tenn. 2003).

    - Even if the parties agree as to the proper methodology to use, there are often significant differences in opinion regarding how to apply those methodologies to the facts.

  - Section 1129(b)(2)'s "fair and equitable" test requires a determination that the secured creditors are being paid what they deserve—often requiring a valuation of the debtors' assets at the time of confirmation.

    - The valuation of assets here will be their "going concern" value at "fair market value"

  - By contrast, in determining whether the "best interest" test under Bankruptcy Code section 1129(a)(7) has been met, a debtor needs to present a liquidation analysis showing that each creditor will receive no less under the plan of reorganization than it would have in a chapter 7 liquidation.

    - The valuation of assets here will be at "liquidation" or "sale" value, rather than going concern value.

- ***Valuation Methodologies Used For Specific Types of Assets***

  - **Intellectual Property ("IP")**

    - As with valuation of other types of assets, valuation of intellectual property should take into account the reason for the valuation and the debtor's proposed use/disposition

- Ownership/right to use issues critical to value determination
- Licensed IP – rejection/assumption issues
- Three basic approaches:
    - Market Approach: value based on similar recent market transactions of comparable assets;
    - Cost Approach: value based on (i) historical cost basis (depreciating based upon reasonable useful life estimate), or (ii) projected cost of replacement or reproduction; and
    - Income Approach: value based on anticipated economic benefit from use (future income stream, duration of income stream, and risks associated therewith).
    - *See Citibank (South Dakota), N.A. v. FDIC*, 827 F.Supp. 789, 793-94 (D. D.C. 1993) (noting that the three valuation methods described above are "generally accepted in appraising intangible assets.")
- In a liquidation: liquidation discount of 30%-90% applied to assets
- Expert testimony needed to support any IP valuation

- **Real Property**
    - Three basic approaches:
        - Market or Sales Comparison Approach (based on comparable sales) (*see, e.g., In re Melgar Enters., Inc.*, 151 B.R. 34 (Bankr. E.D.N.Y. 1993));
        - Cost or Land Development Approach (derives value from actual cost of construction less depreciation)
        - Income Approach (*see, e.g., In re Vienna Park Props.*, 132 B.R. 517 (Bankr. S.D.N.Y. 1991))
            - Two sub-methods (*see In re Southmark Storage Assocs., Ltd. P'ship*, 130 B.R. 9 (Bankr. D. Conn. 1991)):
                - Income/Direct Capitalization Method; and
                - Discounted Cash Flow Method

- In *210 Ludlow St. Corp. v. Wells Fargo Bank, N.A. (In re 210 Ludlow St. Corp.)*, 455 B.R. 443 (Bankr. W.D. Pa. 2011), there was a battle of the experts regarding whether the income capitalization approach or the discounted cash flow method was appropriate in the context of valuing a hotel. Ultimately, the court rejected both expert's valuations, deciding instead on a mid-point between the two.

- **Common Stock**

  - Generally accepted valuation approaches to estimate fair market value of a debtor's common stock include:

    - Discounted Cash Flow Analysis (estimating "value of a company by looking at its anticipated future revenues and applying an appropriate discount rate");

    - Market Multiples Analysis (taking "a particular financial or operational statistic of a publicly traded company and establish[ing] a ratio between that statistic and the value of the company"); and

    - Actual Market Transactions Analysis (considering "certain third-party transactions to be evidence of the fair market value")

    - *See Chatz v. Bearing Point Inc. (In re Nanovation Techs., Inc.)*, 364 B.R. 308, 327-34 (Bankr. N.D. Ill. 2007) (assessing reasonableness of debtor's common stock valuation).

- **Accounts Receivable**

  - As a general matter, in determining the value of accounts receivable, the book value of such accounts will be discounted by a percentage to reflect issues concerning collectability.

    - *See Stadtmueller v. Fitzgerald (In re Epic Cycle Interactive, Inc.)*, No. 08-03289-CL7, Adv. No. 11-90111-CL, 2011 WL 2567170, at **4, 7 (Bankr. S.D. Cal. June 6, 2014) (in determining solvency for purposes of section 547(c), court adopted valuation of accounts receivable that valued accounts at book value less 15%, where discount was based upon actual historical performance of debtor's collection of receivables). *See also Katz v. Wells (In re Wallace's Bookstores, Inc.)*, 316 B.R. 254, 261 (Bankr. E.D. Ky. 2004) (discounting expert's valuation of accounts receivable where expert failed to investigate the collectability of certain receivables. Court held that "fair value" of receivables should be determined by "estimating what the debtor's assets would realize if sold in a

prudent manner in current market conditions."); *Thompson v. Jonovich (In re Food & Fibre Prot., Ltd.)*, 168 B.R. 408, 417 (Bankr. D. Ariz. 1994) ("any reasonable valuation of the receivables would lower their value drastically below the amount listed in the aging report . . . ."); *Carlson v. Rose (In re Rose)*, 86 B.R. 193, 195 (Bankr. W.D. Mo. 1988) ("[a]ccounts receivable need not be taken at face value where circumstances cast doubt on their collectability.").

- The discount applied to the book value of accounts receivable in a **liquidation** is likely to be considerably larger than the discount applied if the business is a going concern, due primarily to concerns regarding non-payment if the company is in liquidation.

    - *See Official Comm. of Unsecured Creditors v. CIBC Wood Gundy Ventures, Inc. (In re Temtechco, Inc.)*, No. 09-00596, 1998 WL 887256, at *11 (Bankr. D. Del. Dec. 18, 1998) (although historical receivable collections neared 100 percent, expert significantly discounted value of the receivables in a liquidation "on the theory that customers might elect not to pay anything . . . adding to the difficulty of collection."); *In re Harman*, 141 B.R. 878, 887 (Bankr. E.D. Pa. 1992) ("liquidation usually makes collection of accounts receivable from customers who cannot anticipate any future relationship with the debtor a difficult proposition."); *In re Pullman Constr. Indus. Inc.*, 107 B.R. 909, 935-36 (Bankr. N.D. Ill. 1990) (finding that the forced liquidation value of the debtor's accounts receivable was 25% of book value); *In re Snider Farms, Inc.*, 79 B.R. 801, 815 (Bankr. N.D. Ind. 1987) ("[a] greater percentage of accounts receivable will ordinarily be collected by a going concern than by one in liquidation.").

- **Inventory**

    - Where debtor intends to continue its business as a **going concern**, courts have recognized different methodologies for valuing a debtor's inventory:

        - **Cost**. *See Samson v. Alton Banking & Trust Co. (In re Ebbler Furniture & Appliances, Inc.)*, 804 F.2d 87, 90-91 (7th Cir. 1986) (in determining value of inventory under section 547, cost of inventory is the proper method of valuation)*; see also In re Nuts & Boltzs, LLC*, No. 09-09615-DD, 2010 WL 5128961, at *3-4 (Bankr. D. S.C. July 2, 2010) (in determining secured creditor's status under section 506, inventory should be valued at wholesale cost rather than retail sales price where debtor seeks to use collateral in ongoing business and could replace the inventory at wholesale cost).

- **Cost Less Likely Discounts to Customers**. *See In re Taxman Clothing Co.*, 905 F.2d 166, 170-71 (7th Cir. 1990) (for purposes of determining whether debtor was insolvent in a preference action, inventory valued at going-concern value, which represented the retail cost less the retailer's mark-up and projected discounts to customers. Court did not have to determine whether wholesale cost, alone, would have been proper valuation methodology).

- **Cost Less Percentage Reduction**. *See In re Phoenix Steel Corp.*, 39 B.R. 218, 228-29 (D. Del. 1984) (valuation of inventory for purposes of determining whether creditor was entitled to adequate protection should be at "fair market value" – cost less discount to reflect the price that a hypothetical reasonable buyer would pay for inventory).

- **Cost Plus Reasonable Mark-Up**. *See Lids Corp. v. Marathon Invest. Partners (In re Lids Corp.)*, 281 B.R. 535, 541-43 (Bankr. D. Del. 2002) (in determining "fair market value" of inventory for purposes of section 547, rejecting secured creditor's adjusted balance sheet valuation methodology that failed to make adjustments to book value of assets to reflect amount debtor could recover if the goods were "offered in a fair market for a reasonable period of time." By contrast, debtor's expert valued inventory at 105% of cost, where expert estimated that the debtor could obtain that amount for the inventory in a reasonable period of time).

- In a **liquidation**, inventory is likely to be valued **below** cost (often times with a significant discount).

  - *See Anderson v. Mega Lift Systems, L.L.C. (In re Mega Systems, L.L.C.)*, No. 03-30190, Adv. No. 04-6085, 2007 WL 1643182, at *4 (Bankr. E.D. Tex. June 4, 2007) (finding that calculation of fair market value of the debtor's inventory in a liquidation at cost was too "generous [a] standard which resulted in a higher than expected financial yield to the Debtor for its inventory assets."); *Geltzer v. Borriello (In re Borriello)*, 329 B.R. 367, 378 (Bankr. E.D.N.Y. 2005) (valuing inventory at one-third of cost where expert testified that "cost does not reflect the value of . . . inventory if it were to be sold to a third party or liquidated in a going out of business sale."); *Silverman Consulting, Inc. v. Hitachi Power Tools, U.S.A., Ltd. (In re Payless Cashways, Inc.)*, 290 B.R. 689, 700 n. 25-26 (Bankr. W.D. Mo. 2003) (competing experts assessing liquidation value of inventory at 76.5% of cost and 35% of cost, respectively); *Official Comm. of Unsecured Creditors v. CIBC Wood Gundy Ventures, Inc. (In re Temtechco, Inc.)*, No. 09-00596, 1998 WL 887256, at *11 (Bankr. D. Del. Dec. 18, 1998) (expert testifying that "inventory was designed for specific customers who would not pay

full value if the company was liquidating" so "the value of Debtor's assets was significantly lower than it would have been if the assets were sold as a going concern."); *In re Tempo Tech. Corp.*, 202 B.R. 363, 369 (D. Del. 1996) (Where inventory consisted of specially ordered finished goods, recognizing expert's testimony that "there is a vast difference in the market valuation of . . . inventory[] of a thriving business versus one that is to be liquidated."); *Sharon Steel Corp. v. Citibank, N.A. (In re Sharon Steel Corp.)*, 159 B.R. 165, 170 (Bankr. W.D. Pa. 1993) (reducing debtor's proposed valuation of inventory from $44.1 million to $27.0 million where certain types of inventory would be "worth substantially less upon liquidation"); *Armstrong v. United Bank of Bismarck (In re Bob's Sea Ray Boats, Inc.)*, 144 B.R. 451, 456 (Bankr. D. N.D. 1992) (valuing parts and inventory at $61,500, even though cost for such parts and inventory was $195,696, where testimony showed that "similar inventories would be valued at liquidation at an approximate discount of 20% to 50%."); *In re Crowthers McCall Pattern, Inc.*, 120 B.R. 279, 293-95 (Bankr. S.D.N.Y. 1990) (for purposes of determining whether objecting creditors would receive more under plan than under hypothetical chapter 7 liquidation, determining that liquidation value of inventory would garner approximately 45% to 50% of its wholesale price); *In re Phoenix Steel Corp.*, 39 B.R. 218, 227-28 (D. Del. 1984) (holding that book value of inventory must be discounted by 35% to arrive at liquidation value).

ISSUE 6: Landlord Claims for Damages and Section 502(b)(6) Cap

- **Damage Claims Do Not Fall Within Statutory Cap**
    - *In re Energy Conversion Devices, Inc.*, 483 B.R. 119 (Bankr. E.D. Mich. 2012)
        - Issue: whether landlord's additional damages claim of $817,942.83, for physical damage to the property including, *inter alia*, damage to the roof, parking lot, HVAC, exhaust units, fire extinguishers, landscaping, and plumbing, was allowable separate from the section 502(b)(6) cap?
        - Under section 502(b)(6), landlord claims "for damages resulting from the termination of a lease of real property" are capped at "the rent reserved by such lease, without acceleration, for the greater of one year, or 15 percent, not to exceed three years, of the remaining term of such lease . . . ."
        - Trustee argued that landlord's "additional damages claim" was subject to the 502(b)(6) cap because it is "part of 'the claim of a lessor for damages resulting from the termination of a lease of real property,' within the meaning of § 502(b)(6)."

- Court recognized split in authority on the issue of whether damages claims are subject to the cap, noting that some courts had interpreted the phrase "damages resulting from termination of a lease" broadly and held that rejection "constitutes a breach of all covenants in the lease, including, . . . covenants requiring the debtor to maintain and repair the premises." Under those cases, "all damage claims by the lessor are subject to the cap . . . ."

- In contrast, other courts have read section 502(b)(6) more narrowly, holding that the cap applies "to solely those damages arising as a consequence of the lease being terminated." *Id.* at 123 (quoting *In re Brown*, 398 B.R. 215, 218 (Bankr. N.D. Ohio 2008)).

    - Under those cases, the pertinent question is if "the landlord would have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?" *Id.* (quoting *Brown*, 398 B.R. at 218-19).

    - If so, "then the claim is ***not*** subject to the § 502(b)(6) cap." *Id.* (quotations omitted).

    - As one court faced with a damage claim for physical damage to the property had held: "The phrase ["damages resulting from the termination of a lease"] suggests that § 502(b)(6) is intended to limit only those damages which the lessor would have avoided but for the lease termination. Any damages caused to the Premises by the Debtor's failure to fulfill its repair and maintenance obligations are unrelated to the termination of the lease." *Id.* at 123-24 (quoting *In re Atlantic Container Corp.*, 133 B.R. 980, 987 (Bankr. N.D. Ill. 1991)).

    - Notably, the Ninth Circuit, in *El Toro Materials*—where the landlord had asserted a physical damages claim after tenant had left "one million tons of its wet clay 'goo,' mining equipment and other materials" on the property after rejecting the lease—had recently held that:

        > The structure of the cap—measured as a fraction of the remaining term—suggests that damages other than those based on a loss of future income are not subject to the cap. It makes sense to cap damages for lost rental income based on the amount of expected rent: Landlords may have the ability to mitigate their damages by re-leasing or selling the premises, but will suffer injury in proportion to the value of their lost rent in the meantime. In contrast, collateral damages are likely to bear only a weak correlation to the amount of rent: A tenant may cause a lot of damage to a

> premises leased cheaply, or cause little damage to premises underlying an expensive leasehold.
>
> . . .
>
> To limit their recovery for collateral damages only to a portion of their lost rent would leave landlords in a materially worse position than other creditors. In contrast, capping rent claims but allowing uncapped claims for collateral damage to the rented premises will follow congressional intent by preventing a potentially overwhelming claim for lost rent from draining the estate, while putting landlords on equal footing with other creditors for their collateral claims.

Id. at 124-25 (quoting *In re El Toro Materials Co., Inc.*, 504 F.3d 978, 978-81 (9th Cir. 2007)).

- Ultimately, the *Energy Conversion* court was persuaded by the reasoning articulated in *El Toro Materials, Atlantic Container Corp.* and other courts adopting a more narrow read of section 502(b)(6), and held that the "additional damages claim" component of landlord's claim was <u>not</u> subject to the section 502(b)(6) cap. *Id.* at 125.

- *See also In re Best Prods. Co., Inc.*, 229 B.R. 673, 678-79 (Bankr. E.D. Va. 1998) (holding that damage claim for deferred maintenance was not subject to 502(b)(6) cap because, among other things, "the primary concern of the drafters of the legislation 'was with limiting *prospective* damage claims' of landlords); *In re Bob's Sea Ray Boats, Inc.*, 143 B.R. 229, 232 (Bankr. D. N.D. 1992) (holding that claims for damage to the premises, including damaged or removed carpeting, wash stall curtain, sprinkler control box, workbench tops, light pulls and light fixtures, "have nothing to do with the kind of damages restricted by application of section 502(b)(6)"); *In re Q-Masters, Inc.*, 135 B.R. 157, 161 (Bankr. S.D. Fla. 1991) (same).

- **Damage Claims Are Subject To Section 502(b)(6) Cap**

  - *In re Foamex Int'l, Inc.*, 368 B.R. 383 (Bankr. D. Del. 2007)

    - Debtors objected to landlords' claim for damages arising from breach of repair and maintenance covenant

      - According to debtors, "case law coupled with legislative history support a ruling . . . that the Section 502(b)(6) cap applies to the Claim without regard to the type of damages involved." *Id.* at 387.

      - Debtors argued that "rejection of a lease constitutes a breach of the lease and all of the lease covenants, including those for repair and

maintenance, and such breach allows a lessor to file a claim for all damages, which then triggers the Section 502(b)(6) cap." *Id.* at 387-88 (citing *Kuske v. McSheridan (In re McSheridan),* 184 B.R. 91 (9th Cir. BAP 1995);[1] *In re Mr. Gatti's, Inc.*, 162 B.R. 1004 (Bankr. W.D. Tex. 1994); and *New Valley Corp. v. Corp. Prop. Assocs. (In re New Valley Corp.)*, No. Civ. A. 98-982, 2000 WL 1251858 (D. N.J. Aug. 31, 2000)).

- Claimants, citing *Atlantic Container Corp., Bob's Sea Ray Boats* and *Best Prods., Inc.*, argued that "[b]ecause the repair and maintenance damages sought by the Claim are unrelated to, and independent of, the termination of the Lease, the damages are not capped by Section 502(b)(6) and should be allowed in their full amount." *Id.* at 390.

- Court agreed with the debtors, holding that "Claimants' damages from the failure, if any, by Debtors to perform the maintenance and repair obligations under the Leases are limited by the statutory cap." *Id.* at 394.

- *See also New Valley Corp. v. Corp. Prop. Assocs. (In re New Valley Corp.),* No. Civ. A. 98-982, 2000 WL 1251858 (D. N.J. Aug. 31, 2000) (after recognizing that "pre-Code law directed that deferred maintenance payments fell within the scope of the cap[,]" holding that the Bankruptcy Court properly held that the claim for such payments was subject to section 502(b)(6)); *In re Mr. Gatti's, Inc.*, 162 B.R. 1004, 1007-14 (Bankr. W.D. Tex. 1994) ("damages suffered by the landlord because [of] the Debtor's rejection of the lease and failure to perform, including its failure to perform its maintenance and repair obligations" are capped by section 502(b)(6)); *In re Storage Tech.*, 77 B.R. 824, 825 (Bankr. D. Colo. 1987) (in a case not involving physical damages, holding that "damage cap applies to all damages" including "non-payment of rent, taxes, costs, attorney's fees, or other financial covenants").

ISSUE 7: Preemption of State Law Constructive Fraudulent Transfer Claims

- Bankruptcy Code section 546(e) bars the avoidance of any transfer that is a "margin payment" or "settlement payment" made to or by (or for the benefit of) a commodity broker, forward contract merchant, stockbroker, financial institution, financial participant, or securities clearing agency, in connection with a securities contract, commodity contract, or forward contract. Sections 546(f) and (g) also protect transfers

[1] The court in *McSheridan* dealt with two distinct issues: (i) whether the phrase "rent reserved by such lease" in section 502(b)(6) includes other expenses not designated as "rent" or "additional rent" and (ii) whether damages resulting from breach of covenants in a real property lease are damages "resulting from termination" under section 502(b)(6). 184 B.R. at 96. Notably, *McSheridan's* holding with respect to issue (ii) was expressly overruled by the court in *El Toro*. *See El Toro Materials Co., Inc.*, 504 F.3d at 981 ("To the extent that *McSheridan* holds section 502(b)(6) to be a limit on tort claims other than those based on lost rent, rent-like payments or other damages directly arising from a tenant's failure to complete a lease term, it is overruled."). *Foamex* was decided a few months before the court in *El Toro* issued its decision, so it is not clear how it would have come out had *El Toro* been decided first.

made in connection with swaps and repos. These Code sections create what are referred to as "safe harbors."

- Creditors, with mixed results, have attempted to get around the restrictions of the safe harbors by pursuing avoidance actions outside of the bankruptcy process.

    - ***State Law Constructive Fraudulent Transfer Claims Preempted By Bankruptcy Code***

        - In *Whyte v. Barclays Bank PLC*, 494 B.R. 196 (S.D.N.Y. 2013) ("*SemGroup*"), the district court ruled for the defendants, holding that the litigation trustee's avoidance action was barred by section 546(g) of the Bankruptcy Code, even though the litigation trustee was purporting to assert state law claims. According to the court, the state law claims were "an obstacle to the accomplishment and execution of the full purposes and objectives of Congress" in enacting section 546(g) and, thus, were impliedly preempted by 546(g). *Id.* at 200. Any other interpretation "would, in effect, render section 546(g) a nullity." *Id.* at 199.

    - ***State Law Constructive Fraudulent Transfer Claims <u>Not</u>* Preempted**

        - In *In re Tribune Co. Fraudulent Conveyance Litigation*, 499 B.R. 310 (S.D.N.Y. 2013), the United States District Court for the Southern District of New York held that the right of individual creditors to assert claims for constructive fraudulent conveyance under state law was *not* preempted by the safe harbor provisions of Bankruptcy Code section 546(e). The court found that the *SemGroup* case was "readily distinguishable" because, in that case, one entity – the SemGroup Litigation Trust – was designated "to serve in the capacity of both the bankruptcy trustee and the representative of outside creditors." *Id.* at 319. Where, as in *Tribune*, the state law claims were brought by individual creditors who are not "creatures of a Chapter 11 plan, and . . . are in no way identical with the bankruptcy trustee. . ., there is no reason why Section 546(e) should apply to them in the same way that Section 546(g) applied to SemGroup." *Id.* Even though the court found that the individual creditors' state law claims were not preempted, the creditors were not, ultimately, permitted to pursue those claims, because "[u]nless and until the Committee actually and completely abandons those claims, the Individual Creditors lack standing to bring their own fraudulent conveyance claims targeting the very same transactions." *Id.* at 325.

        - United States Bankruptcy Judge Gerber recently endorsed the *Tribune* decision in *Weisfelner v. Fund 1 (In re Lyondell Chem. Co.)*, 503 B.R. 348 (Bankr. S.D.N.Y. 2014). In *Lyondell*, Judge Gerber held that section 546(e), which provides that "the *trustee* may not avoid a transfer[,]" does <u>not</u> preempt state law claims brought by *individual creditors* or a trust acting on their behalf. *Id.* at 358-59 (quoting 11 U.S.C. § 546(e) (2006)

(emphasis added by *Lyondell* court)). Judge Gerber also concluded that, "[c]onsistent with the thoughtful decision in *Tribune*, . . . the state law constructive fraudulent transfer laws . . . are not preempted." *Id.* at 359 (citing *Tribune*, 499 B.R. at 320). In so holding, the court joined *Tribune* in distinguishing the *SemGroup* decision because, in that case, the trust pursuing the claims was "itself a 'creature of the Chapter 11 plan'." *Id.* at 374-75 (quoting *Tribune*, 499 B.R. at 319). In contrast, in *Lyondell*, "estate claims and creditor claims are not being asserted by the same trust, and the Creditor Trust is not also asserting claims on behalf of the Lyondell estate." *Id.* at 375. The *Lyondell* court also noted that "it ha[d] reservations as to the correctness of the 'bottom-line' judgment in [*SemGroup*]" where the "analysis [was] . . . less than thorough than that of *Tribune*, and . . . a number of the elements of the *Barclays* analysis [were considered] to be flawed." *Id.* at 376.

ISSUE 8: Permissibility of Third Party Releases

- **Minority Approach: Third Party Releases Are Impermissible As A Matter Of Law**
  - The Fifth, Ninth and Tenth Circuits have held that non-debtor third party releases are impermissible as a matter of law.
    - *See Feld v. Zale Corp. (In re Zale Corp.)*, 62 F.3d 746, 760-61 (5th Cir. 1995) (where permanent injunction "provided no alternative means . . . to recover from [third party] . . . [it] improperly discharged a potential debt of [third party]" and "the bankruptcy court exceeded its powers under § 105."); *Resorts Int'l, Inc. v. Lowenschuss (In re Lowenschuss)*, 67 F.3d 1394, 1401-02 (9th Cir. 1995) (holding that third party release violates section 524(e), which "precludes bankruptcy courts from discharging the liabilities of non-debtors."); *Underhill v. Royal*, 769 F.2d 1426, (9th Cir. 1985) ("the bankruptcy court has no power to discharge the liabilities of a nondebtor pursuant to the consent of creditors as part of a reorganization plan."); *Landsing Diversified Properties-II v. First National Bank and Trust Co. (In re Western Real Estate Fund, Inc.)*, 922 F.2d 592, 600-02 (10th Cir. 1991) ("Congress did not intend to extend such benefits [of discharge] to third-party bystanders.").
  - These courts have narrowly interpreted Bankruptcy Code section 524(e), which provides that "the discharge of a debt of the debtor does not affect the liability of any other third entity on, or the property of any other entity for such debt."
  - According to these courts, third party releases effectively allow the bankruptcy process to discharge non-debtors, a result clearly inconsistent with section 524(e).

- **Majority Approach: Third Party Releases Are Permissible In Certain Limited Circumstances**

    - The Second, Third, Fourth, Sixth and Seventh Circuits have permitted third party releases, but only in limited circumstances.

        - *See S.E.C. v. Drexel Burnham Lambert Group, Inc. (In re Drexel Burnham Lambert Group, Inc.)*, 960 F.2d 285, 293 (2d Cir. 1992) ("a court may enjoin a creditor from suing a third party, provided that the injunction plays an important part in the debtor's reorganization plan."); *Gillman v. Cont'l Airlines (In re Cont'l Airlines)*, 203 F.3d 203, 212 (3d Cir. 2000) ("non-consensual releases by a non-debtor of non-debtor third parties are to be granted only in 'extraordinary cases.'"); *In re Menard-Sanford v. Mabey (A.H. Robins Co., Inc.)*, 880 F.2d 694, 702 (4th Cir. 1989) (holding that section 546(e) must not be "literally applied in every case as a prohibition on the power of the bankruptcy courts" to approve a third party release); *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 656-67 (6th Cir. 2002) (holding that section 546(e) merely "explains the effect of a debtor's discharge" and "does not prohibit the release of a non-debtor."); *In re Specialty Equip. Cos., Inc.*, 3 F.3d 1043, 1047 (7th Cir. 1993) ("[w]hile a third party release . . . may be unwarranted in some circumstances, a per se rule disfavoring all releases in a reorganization plan would be similarly unwarranted, if not a misreading of [section 546(e)].").

    - Courts have differed regarding the appropriate standard for evaluating whether a third party release is permissible, but generally have approved such releases only in "extraordinary circumstances." *See Deutsche Bank AG v. Metromedia Fiber Network, Inc. (In re Metromedia Fiber Network, Inc.)*, 416 F.3d 136, 141 (2d Cir. 2005) ("it is clear that . . . [a third party] release is proper only in rare cases."); *In re Washington Mutual, Inc.*, 442 B.R. 314, 351 (Bankr. D. Del. 2011) (third party releases "are the exception, not the rule").

        - With Consent: courts have generally held that third party releases are permissible where the third party consents to the release, including consent by voting affirmatively in favor of a plan containing the releases.

            - *See Specialty Equip. Cos.*, 3 F.3d at 1047 ("releases that are consensual and non-coercive . . . [are] in accord with the strictures of the Bankruptcy Code."); *In re Central Jersey Airport Services, LLC*, 282 B.R. 176, 182 (Bankr. D. N.J. 2002); *In re Monroe Well Service, Inc.*, 80 B.R. 324, 334-35 (Bankr. E.D. Pa. 1987).

            - Two bankruptcy courts in the District of Delaware have recently issued conflicting decisions concerning the type of the "consent" needed for third party releases. *Compare Washington Mutual*, 442

B.R. at 354-55 with *In re Indianapolis Downs, LLC*, 486 B.R. 286, 304-06 (Bankr. D. Del. 2013)

- In *Washington Mutual*, Judge Walrath held that "affirmative consent" is required for a party to be bound by a third party release contained in a plan. 442 B.R. at 354-55. In that case, after amendments by the debtors to satisfy the concerns of the court, the ballot contained an "opt out" provision, where affected parties needed to check the opt-out box in order for the release provisions not to apply. *Id.* Judge Walrath held that consent could not be implied if a party failed to return its ballot, returned a blank ballot, or voted against the plan. *Id.* at 355. Instead, the only way for a party to "consent" to the release was to return the completed ballot voting in favor of the plan and not check the opt-out box. *Id.* ("any third party release is effective only with respect to those who affirmatively consent to it by voting in favor of the Plan and not opting out of the third party releases.").

- In contrast, Judge Shannon in *Indianapolis Downs* (another third party release case where there was an "opt-out" box on the ballot) held that affirmative consent is not required for a party to be bound. 486 B.R. at 304-05. Instead, consent could be implied if a creditor merely failed to return its ballot (or does not otherwise check the "opt-out" box). *Id.* "[T]hose who fail to opt out [by checking the opt-out box], or to vote, are 'deemed' to consent to the Third Party Release." *Id.* at 305. Thus, a creditor will be bound by the third party release if it (i) does not return its ballot, (ii) votes to accept the plan but does not check the "opt-out" box, (iii) returns a blank ballot, or (iv) votes to reject the plan but does "not otherwise opt out of the releases[.]" *Id.* at 304-06.

- Second Circuit Test: *Metromedia Fiber Network, Inc.*

  - In disapproving non-debtor release, holding that "nondebtor release[s] in a plan of reorganization should not be approved absent the finding that truly unusual circumstances render the release important to the success of the plan . . . ." 416 B.R. at 143 (emphasis added).

  - In determining whether the release is permissible, the court noted that focus should be paid to the following factors:

    - Whether estate received substantial consideration;

- Whether enjoined claims are channeled to a settlement fund rather than extinguished

- Whether enjoined claims would indirectly impact debtor's reorganization "by way of indemnity or contribution";

- Whether plan otherwise provides for full payment of enjoined claims; and/or

- Whether there is consent of affected creditors. *Id.* at 142-43.

- Court noted, however, that whether a non-debtor release is permissible is "not a matter of factors or prongs" and that "[n]o case has tolerated nondebtor releases absent the finding of circumstances that may be characterized as unique." *Id.* at 142.

- Involuntary Third Party Release: Multi-Factor Test

  - **5-Factor Test**

    - Identity of interest between debtor and non-debtor such that a suit against the non-debtor will deplete estate resources;

    - Substantial contribution to the plan by non-debtor;

    - Necessity of release to the reorganization;

    - Overwhelming acceptance of the plan and release by creditors and interest holders; and

    - Payment of all or substantially all of the claims of the creditors and interest holders under the plan.

      - *See In re Master Mortg. Inv. Fund, Inc.*, 168 B.R. 930, 934-35 (Bankr. W.D. Mo. 1994) (citing cases applying a variety of the five factors); *Indianapolis Downs*, 486 B.R. at 303 (applying *Master Mortg.* test); *In re Zenith Elecs. Corp.*, 241 B.R. 92, 110 (Bankr. D. Del. 1999) (same).

    - "No court has set out a rigid "factor test" to be applied in every circumstance. Rather, the courts have engaged in a fact specific review, weighing the equities of each case. The courts seem to have balanced the five listed factors most often. However, these factors do not appear to be an exclusive list of considerations, nor are they a list of conjunctive requirements." *Master Mortg. Inv. Fund*, 168

B.R. at 935; *see also Indianapolis Downs*, 486 B.R. at 303 ("[t]hese factors are neither exclusive nor are they a list of conjunctive requirements.").

- **6-Factor Test**

  - The Sixth Circuit, in *Class Five Nevada Claimants v. Dow Corning Corp. (In re Dow Corning Corp.)*, 280 F.3d 648, 658 (6th Cir. 2002) adopted a variation of the five-factor test, adding one additional factor, namely:

    - the plan provides an opportunity for those claimants who choose not to settle to recover in full.

  - The Fourth Circuit recently adopted this 6-factor test. *See Nat'l Heritage Foundation, Inc. v. Highbourne Foundation*, No. 13-1608, 2014 WL 2900933, at *1-2 (4th Cir. June 27, 2014).

CASELAW ADDENDUM TO MATERIALS

ISSUE 4: Trustee's Commissions/Fees Under Bankruptcy Code §§ 326 and 330

- ***Trustee is Per Se Entitled to Cap Absent Extraordinary Circumstances*** (Materials, pp. 8-9)

  - *Mohns, Inc. v. Lanser*, 2015 WL 138116 (E.D. Wisc. January 12, 2015)

    - □ Court affirmed order awarding compensation to chapter 7 trustee based on distributions in case.

    - □ With respect to chapter 7 trustees, "reasonable compensation" should be understood as being a commission calculated under the formula set forth in § 326. *Id.* at *5.

    - □ A chapter 7 trustee is presumed to be entitled to a commission calculated under the statutory formula based on funds distributed in a bankruptcy case, and while a court has the power to reduce the commissions below the amount specified by the formula, it should exercise this power sparingly. *Id.* at *6.

    - □ A court should avoid adjusting a trustee's commission below the amount calculated using section 326's statutory formula solely based on its conception that the statutory commission is disproportionate to the time or effort spent on a particular case. *Id.*

    - □ The trustee's failure to submit a detailed fee application is not grounds to deny or reduce compensation which is commission-based and not dependent on services rendered or time expended. *Id*. at *7.

    - □ Where there is no dispute over what qualifies as "moneys disbursed or turned over in a case," the court does not have to hold an evidentiary hearing or make detailed findings of fact in order to award compensation to a chapter 7 trustee. *Id.* at *8.

ISSUE 6: Landlord Claims for Damages and Section 502(b)(6) Cap

- ***Damage Claims Do Not Fall Within Statutory Cap*** (Materials, pp. 15-17)

  - *In re Denali Family Services*, 506 B.R. 73 (Bankr. D. Alaska 2014)

    - □ While the Bankruptcy Code governs the amount of rent recoverable by a lessor for damages resulting from termination of a lease of real property, it does not cap a lessor's claims against a debtor/lessee for collateral damages that arise independent of the rejection of the lease in bankruptcy. *Id.* at 78.

    - □ Adopts the Ninth Circuit's "simple" test (set forth in *El Toro Materials Co., Inc.,* 504 F.3d 978 (9th Cir. 2007)) to determine whether a lessor's claims result from the rejection of the lease: "[a]ssuming all other conditions remain constant, would the landlord have the same claim against the tenant if the tenant were to assume the lease rather than rejecting it?" In other words, if the debtor had assumed and performed under the lease, would the claim still remain? If so, the claim exists independently of the lease rejection, and is beyond the statutory cap." *Id.* at 79 (internal citations omitted).

    - □ Claims for future rent, real property taxes, tenant improvements, utilities, real estate commissions and remodeling costs only existed as a result of the rejection of the lease and were therefore subject to the section 502(b)(6) cap. *Id.* at 82-83.

    - □ Claim for removal of tenant improvements existed independently of the lease rejection and therefore fell outside of section 502(b)(6) limitations. *Id.* at 83.

  - *Kupfer v. Salma* (*In re Kupfer),* 2014 WL 4244019 (N.D. Cal. August 26, 2014)

    - □ Court held that attorneys' fees and costs awarded against chapter 11 debtors/tenants in a pre-petition arbitration proceeding that established the debtor's obligations for breach of commercial leases were not subject to the section 502(b)(6) cap on lease termination damages. Rather, the fees and costs were non-rent damages that were collateral to the termination of the leases. *Id.* at *6.

    - □ Applying the Ninth Circuit's reasoning in *El Toro* in the context of pre-petition fees and costs, the court held that these fees and costs bore only a weak correlation of the amount of rent owned, and the allowance of such amounts was necessary to put the landlord on equal footing with other creditors who might have obtained judgments because they were damaged by the debtors' conduct. *Id.*

IN THE UNITED STATES BANKRUPTCY COURT

In re:	)	Chapter 11
	)	
Overleveraged, Debtor	)	Case No. 12-34567
	)	
	)	Honorable Judge Judy
	)	
	)	

DECLARATION OF KELLY STAPLETON IN SUPPORT OF THE PLAN OF LIQUIDATION

I, Kelly Stapleton, hereby declare that the following is true to the best of my knowledge, information, and belief:

1. I am presently a Managing Director with A&M and lead A&M's Unsecured Creditors' Committee practice. Industry expertise spans the public sector, retail, banking, manufacturing, logistics, and professional service sectors. Ms. Stapleton has previously served as a liquidating trustee, including in the *In re Mount Vernon Monetary Management Corp., et al.* chapter 11 bankruptcy cases, Case No. 10-23053 (RDD) (Bankr. S.D.N.Y.). Ms. Stapleton was also appointed the plan administrator in the *In re FKF Madison Group Owner LLC, et al.* chapter 11 bankruptcy case (Case No. 10-11867-KG) (Bankr. D. Del.), in which she was tasked with the reconciliation of claims and the distribution of assets. Before working for A&M, Ms. Stapleton was a managing director with two financial advisory firms in New York, representing debtors and creditors in reorganizations, liquidations, Section 363 sales and fraud investigations. Similarly, Ms. Stapleton previously served as the U.S. Trustee for Region 3, appointed by the U.S. Attorney General in January 2005. In this role, she managed five state offices and was accountable for all bankruptcies filed in Delaware, Pennsylvania and New Jersey.

2. A&M was retained by Overleveraged (the "Debtor") in the above-captioned matter in October 2013 as financial advisor to assist in the Debtor in the bankruptcy case.

I. The Plan is in the Best Interests of All the Debtors' Creditors (Section 1129(a)(7)).

3. The Liquidation Analysis clearly demonstrates that the value that may be realized by the Holders of Claims and Equity Interests in connection with a disposition of the Debtors' assets in a hypothetical chapter 7 liquidation is equal to or less than the value of the recoveries (if any) to such Classes provided for under the Plan.

4. In particular, the Committee believes that, consistent with the Liquidation Analysis I prepared (and which was attached to the Disclosure Statement) distributions under a hypothetical chapter 7 liquidation would be less than distributions under the Plan for numerous reasons, including the following:

- **Fraudulent Transfer Issue**: The fraudulent transfer action is barred by section 546(e). The term loan transaction and the acquisition of the coal operations (which was structured as a stock transaction) was a unified transaction that was handled through a financial institution; the safe-harbor bars the fraudulent transfer action. Apart from the impending release under the plan, the term loan was part of a settlement payment made by a financial institution and was also a transfer made by a financial institution in connection with a securities contract. Additionally, there would not be funding in chapter 7 to enable the chapter 7 trustee to pursue such frivolous claims, because the term lenders would never agree to use of cash collateral to fund a lawsuit against themselves. Unsecured creditors such as the landlord cannot bring a state law claim because only the trustee or the debtor in possession can bring avoiding actions and, in any event, even if unsecured creditors could obtain

standing to bring a state law fraudulent conveyance action, the creditors cannot circumvent the safe harbor because Congress intended to preempt the "avoiding action field" whenever a bankruptcy case has been filed and, consequently, any effort to bring a separate fraudulent transfer action outside the confines of the bankruptcy case is either forbidden or doomed to failure because the safe harbor will still be available as a defense, especially if the intended effect of bringing that action would be to permit parties that Congress intended to protect with the safe harbor to be exposed to liability for otherwise protected transactions.

- **Trustee Commissions**: The liquidation analysis has taken all of the expected cash that will be available for distribution and multiplied it by the statutory percentages set forth in section 326(a). I believe the chapter 7 commissions are justified because BAPCPA has altered prior case law by omitting any reference to chapter 7 trustees in Bankruptcy Code section 330(a)(3) and by providing in section 330(a)(7) that in determining the amount of reasonable compensation to be awarded to a trustee, the court shall treat such compensation as a commission based on section 326, because such compensation is still reasonable in light of all of the other work that has to be done by the trustee. Additionally, the statute expressly contemplates that the trustee's commission will be calculated based on all moneys "disbursed or turned over" to creditors by the trustee without regard to how those moneys were accumulated by the trustee, and because it is not unreasonable to permit a panel trustee that often loses money on her cases to cash in once in a while, otherwise no one could make a living as a panel trustee and the system would crash without such trustees.

- **Landlord**: The landlord believes its claim is much higher than the capped claim Overleveraged has used in its liquidation analysis. It is my professional opinion that the landlord's lease rejection claims subsumes all claims under the lease, and therefore, regardless of the merit of the claim for damages to the premises, upon rejection, that claim is part of the cap imposed on the landlord's claim under Bankruptcy Code section 502(b)(6). Put another way, rejection terminates all covenants and provisions of the lease and any claim under any provision of the lease will fall under the cap.
- **Third Party Releases**: I believe the third party releases including the releases to the lenders and the Debtors' officers and directors are appropriate. The term lenders are released from any claims arising out of or related to the loans made to the debtor or in any way related to the lender-borrower relationship. The officers and directors are released from any and all claims in any way related to Overleveraged. The lenders release is justified as the lenders have promised essential financing or use of cash collateral to fund the wind down and sale of the coal operations and the sale of the other yet to be liquidated assets. The release of the CEO is required to maximize value to the estate as the CEO is vital to the post-confirmation sale of the coal operations and the other liquidation efforts, and that the release is a condition of his staying.

Pursuant to 28 U.S.C. § 1746, I declare under penalty of perjury that the foregoing is true and correct to the best of my knowledge, information, and belief.

Dated: August __, 2014

Respectfully submitted,

Kelly Stapleton