

Ethics: Chapter 11 Commission Recommendations on Professional Fees and Expenses

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Summary of Key Labor Related Concepts:

Priority for wages and employee benefit plan contributions: The Commission is recommending changes to update and simplify the statutory priority for wages and employee benefit plan contributions.

- The amount of the wage priority would be increased to \$25,000 per employee; the 180-day earnings period would be eliminated; the new amount would adjust periodically for inflation as under current law.
- The new per employee amount would be applied to all forms of compensation and benefit plan payments now covered by sections 507(a)(4) and (5).
- The debtor would not need to obtain court approval to pay pre-petition wages and plan contributions up to the amount of the new cap. Pre-petition wages and benefits in excess of the new cap could still be paid under the “doctrine of necessity,” as under current law, subject to the court’s approval.

Procedures under Section 1113: The Commission is recommending refinements to the current statutory process to more clearly separate the bargaining process from the litigation process in order to encourage negotiated resolutions where a debtor seeks changes to a labor agreement.

- New procedures would formalize the notification of the debtor’s intent to seek modifications, and delivery of a proposal and the required information to the authorized representative
- An initial conference would be held by the court where preliminary issues related to the initiation of the bargaining process; appointment of a mediator would be considered, but would not be mandatory; a timetable for negotiations would be outlined
- If, after a reasonable period of time consistent with the parties’ projected timetable, negotiations did not produce a mutually satisfactory agreement, the debtor could then request a case management process for a motion to reject the labor agreement; the court could set an outside date for commencement of a trial no later than 180 days following the initial conference, subject to extensions, absent a negotiated resolution

Retiree Benefits Under Section 1114: The Commission is recommending that the debtor comply with the section 1114 process for modifying retiree benefits where modifications are sought, even where the debtor contends that the benefits may be unilaterally modified; however, the debtor’s use of the process would not create any new claims arising from termination or modification of retiree benefits under section 1114; any such claims would be determined consistent with nonbankruptcy law.

Other principles: The Commission also addressed WARN Act claims, severance pay benefits, rejection damages under Section 1113.

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Key Cost-Saving Aspects of Principles:

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

- The Commission identified, analyzed, and, wherever possible, proposed principles to resolve splits in the case law governing chapter 11 cases to reduce the need for litigation and provide greater certainty about outcomes. To this end, the Commission sought to resolve the following splits, among others:
 - The standard of review applicable to the appointment of a chapter 11 trustee under section 1104;
 - The permissibility of cross-collateralization and roll-up provisions in postpetition financing facilities;
 - The proper use of the doctrine of necessity in chapter 11 cases;
 - The ability of drop shipment transactions to qualify for administrative claim treatment under section 503(b)(9);
 - The interplay between the priority afforded to wage claims under section 507(a)(4) and the priority afforded to employee benefit plan claims under section 507(a)(5);
 - The ability of a debtor to apply section 1114 to terminate retiree benefit plans that the debtor has the right to unilaterally terminate outside the bankruptcy context;
 - The definition of “executory contract” for purposes of section 365;
 - The effect of rejecting an executory contract or unexpired lease under section 365;
 - The ability of a debtor to assume intellectual property licenses under section 365(c) (i.e., the hypothetical test versus the actual test) and the treatment of trademark licenses generally;
 - The proper calculation of a landlord’s claim against the estate (i.e., the accrual approach versus the billing date approach);
 - The application of the safe harbor in section 546(e) to bar fraudulent transfer actions brought under applicable nonbankruptcy law (i.e., state laws including the Uniform Fraudulent Transfer Act or similar statutes as adopted in each state);
 - The treatment of ordinary supply contracts as qualified financial contracts subject to the protection of the Bankruptcy Code’s safe harbor provisions;
 - The meaning of “for the benefit of the estate” under section 550;
 - The fiduciary duties of a debtor (as opposed to a debtor in possession) proposing a chapter 11 plan;
 - The fiduciary duties of professionals paid from the estate; and
 - The permissibility of gifting and nonconsensual third party releases in the context of a chapter 11 plan.

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- The requirement that a debtor identify and disclose information relevant to valuation issues earlier in the case should provide a more transparent and expedient chapter 11 process for all parties in interest.
- The creation of an “estate neutral” offers the court, the debtor, and other parties in interest a tool to more cost-effectively investigate and resolve disputes and other potential barriers to a debtor’s reorganization efforts.
- The enhanced procedures governing a debtor’s request to modify or terminate a collective bargaining agreement under section 1113 should encourage (i) the debtor to initiate this process earlier in the case and (ii) both the debtor and authorized representatives to undertake meaningful negotiations before moving forward with litigation strategies.
- A clear set of rules governing a sale of all or substantially all of a debtor’s assets in chapter 11—with appropriate protections and adequate time to allow the court, the debtor’s stakeholders, and potential bidders to identify and resolve issues relating to the debtor’s proposed exit strategy—should reduce delay and risk of losing value for the estate and should simplify and expedite procedures.
- The ability of a debtor or plan proponent to cram down a chapter 11 plan without the need to have an accepting impaired class of claims should eliminate both manipulative, strategic, and tactical maneuvering by the debtor and creditors (e.g., class construction, acquiring blocking positions within classes, etc.) and litigation concerning classification and impairment issues and focus the confirmation process on the merits of the plan.
- Similarly, the refinement of the absolute priority rule to permit distributions to junior creditors when supported by the reorganization value and redemption option in the case, as well as the codification of the new value corollary, should reduce litigation and expedite the confirmation process.
- Specific guidelines tailored for small and medium-sized enterprises should streamline and simplify the chapter 11 process for these kinds of debtors and eliminate litigation and expense concerning the new value corollary, the absolute priority rule, and the section 1129(a)(10) issues that are prevalent in these cases.

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Summary of Some of What the Principles Do:

- Maintain the debtor in possession model and clarify the duties of directors, officers, and other managing persons
- Clarify appointment and objection process for chapter 11 trustees
- Authorize the appointment of estate neutrals to assist with specified matters in the case
- Require additional disclosures by debtors earlier in the case to assist with valuation-related issues
- Propose a number of cost-saving measures for chapter 11, including expressly allowing innovation in professionals' fee arrangements
- Continue to require adequate protection of a prepetition secured creditor's interest in the debtor's property in certain instances, but determining the extent of adequate protection based on the secured creditor's foreclosure rights under applicable nonbankruptcy law, and expressly providing that a secured creditor is entitled to receive the reorganization value of its interest in the debtor's property upon plan confirmation or an order approving a section 363x sale (i.e., a sale of all or substantially all of the debtor's assets)
- Continue to allow certain protections for postpetition lenders and expressly authorize sales of substantially all of a debtor's assets (with a well-defined approval standard), provided that a general 60-day moratorium applies to (i) effecting extraordinary financing provisions and (ii) conducting an auction or seeking final approval of sale order
- Clarifying the treatment of vendor claims: maintaining section 503(b)(9) (including for drop shipments), allowing payment of certain prepetition vendor claims for services and goods not covered by section 503(b)(9), eliminating reclamation rights, requiring additional diligence and disclosures in preference litigation, and raising the dollar limits on the preference defense and venue provisions
- Increasing the amount of priority claims for employees and providing a more defined process for collective bargaining agreement negotiations
- Narrowing certain aspects of the safe harbors for financial contracts by, among other things, eliminating protection for private transactions in the LBO context, excluding ordinary supply contracts, eliminating walkaway clauses, and narrowing the definitions of repurchase agreements and securities contracts


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- Clarifying a debtor’s right to use and assign intellectual property licenses, and expanding the definition of intellectual property licenses to include trademarks and foreign intellectual property
- Clarifying the definition of “rents” under the Bankruptcy Code, clarifying the calculation of rejection damages for real property leases, and modifying (but eliminating) the trustee’s time to assume or reject nonresidential real property leases
- Creating efficiencies in the plan process by eliminating the need for an accepting impaired class of creditors to cram down a plan, clarifying and codifying the new value corollary, and providing a mechanism to distribute value to a junior class of creditors when supported by the reorganization value of the debtor
- Providing a framework for small and medium-sized debtors that will reduce barriers and help facilitate their reorganizations. The framework, among other things: allows such cases to proceed without a committee, but with enhanced assistance from an estate neutral when ordered by the court; removes the current small business debtor case deadlines for filing and confirming a plan; allows the debtor to propose a timeline for its case and directs the court to set deadlines for filing and soliciting acceptances of a plan; and provides a plan structure that allows the founders or other prepetition equity holders to retain their ownership interests upon the debtor’s emergence from bankruptcy. The SME framework also incorporates many of the general principles proposed by the Commission, including those developed to achieve cost savings and efficiencies in chapter 11 cases.

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Summary of Some of What the Principles Do *Not* Do:

- Impose a mandatory surcharge
- Eliminate adequate protection
- Significantly restrict or curb postpetition lending
- Eliminate the ability to sell substantially all of a debtor's assets outside a plan
- Eliminate credit bidding
- Prohibit claims trading
- Impose increased disclosure requirements on creditors
- Eliminate the financial contracts safe harbors
- Eliminate committees
- Eliminate section 503(b)(9)
- Eliminate a deadline on the trustee's assumption or rejection of nonresidential real property leases
- Extend a debtor's exclusivity periods
- Adopt Till as an appropriate cramdown interest rate



COMMISSION TO
STUDY THE REFORM
OF CHAPTER 11

2012-2014
FINAL REPORT AND RECOMMENDATIONS
SPONSORED BY THE ARTHUR H.N. SCHALLING ENDOWMENT FUND

ABI Commission to Study the Reform of Chapter 11

Overview of
Recommendations and Findings

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Why Reform? Why Now?

- An effective and predictable business bankruptcy scheme rebuilds companies, preserves jobs, and fosters economic growth
- Distressed companies are not using chapter 11, or are waiting too long to use it, undercutting its utility for all stakeholders
 - Perception is chapter 11 does not work for many distressed debtors

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Approach to Reform

- Who: The 18 voting and four *ex officio* Commissioners are among the most prominent chapter 11 professionals in the U.S. today, supported by more than 130 others who served on 13 topical advisory committees
- Objective study of chapter 11: *What is working and what is not working as well as it could?*

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Approach to Reform

- How: Commissioners held 17 field hearings around the country to gather testimony, while considering hundreds of other written submissions, and evaluating empirical data
- Process included perspectives and significant input from representatives of all major stakeholders in chapter 11 cases

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Approach to Reform

- There were no pre-determined principles, agendas, or outcomes
- Commission studied and considered all potentially competing interests in working to strike balanced approach under proposed principles

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Key Themes of Recommendations

- Reduce barriers to entry
- Facilitate certainty and more timely resolution of disputed matters
- Enhance exit strategies for debtors
- Create an effective alternative restructuring scheme for small and medium-sized firms

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Key Principles: SME

- For purposes of these principles, the term “***small or medium-sized enterprise***” (“***SME***”) means a business debtor with—
 - (i) No publicly traded securities in its capital structure or in the capital structure of any affiliated debtors whose cases are jointly administered with the debtor’s case; and
 - (ii) Less than \$10 million in assets or liabilities on a consolidated basis with any debtor or nondebtor affiliates as of the petition date
- SAREs excluded from SME principles

(Report, at 279)

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Key Principles: SME

- No mandatory creditors’ committee; may appoint estate neutral to help with business and plan
- No mandatory deadlines, but SME must propose, and court will approve, timeline tailored to particular case
- Prepetition equity holders may retain their interests, subject to certain conditions
 - These conditions include satisfying section 1129(b) for secured creditors
 - Granting unsecured creditors 85% of economic ownership interests in reorganized company with limited voting rights

(Report, at 291, 294, 297)

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Key Principles: Costs in Chapter 11

- Promote efficiencies and reduce litigation costs by resolving uncertainty and circuit splits in current law
 - Other cost savings:
 - No mandatory committee in SME cases
 - Replace examiners who have open-ended charge with task-specific estate neutrals
 - Streamline confirmation process
 - Simplify and clarify rules to govern asset sales
 - Allow payment of employees' and vendors' priority claims without motion
 - Subject estate-paid creditors' professionals' fees to reasonableness review under section 330
 - Promote innovation in professionals' fee structures by permitting alternative fee arrangements

(Report, at 55, 59-61)

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Key Principles: Estate Neutral

- Appointed by U.S. Trustee
- Never mandatory
- Would replace examiners
- Flexibility, with some limitations, is the key
 - Role is defined by parties and court's order, and
 - Tailored to particular case

(Report, at 32)

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Key Principles: Executory Contracts and Unexpired Leases

- Adopts Countryman definition of executory contracts, provided that forbearance does not constitute performance
- Trustee would have no obligation to perform pending treatment decision, other than paying for goods or services needed and delivered postpetition
- Nonmonetary obligations that cannot be cured would not preclude assumption of any contract or lease
- Rejection would be treated as breach
- Period to assume or reject nonresidential real property leases would be extended to one year
- Definition of rent would be clarified, as would calculation formula for rejection damages claims under section 502(b)(6)

(Report, at 112, 115-116, 119, 129-130)

11

Key Principles: IP

- All IP licenses could be assumed and would be freely assignable, subject to nondebtor licensor's right to object if proposed assignee is a competitor
- Trademarks would be included in definition of IP, subject to certain modifications to section 365(n) particular to trademarks
- Foreign IP would be included

(Report, at 122, 126)

12

Key Principles: Section 363x Sale

- New procedures for sales of substantially all of a debtor's assets
- Not permitted during first 60 days of case, absent extraordinary circumstances proven by clear and convincing evidence
- Must satisfy certain conditions customary in plan process and provide sufficient notice
- Section 363(f) expanded to include claims in context of section 363x sales (or smaller sales meeting similar conditions)

(Report, at 83, 201, 141-142)

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Key Principles: General Plan Provisions

- Move to a "one creditor, one vote" rule for numerosity
- Expressly permit third party releases and exculpation clauses satisfying certain conditions
- Eliminate section 1129(a)(10) and codify the new value corollary
- Market-based approach to cramdown interest rate (rejects *Till*)
- Provide distribution to junior creditors *if* supported by reorganization value of firm

(Report, at 257, 252, 250, 224, 234, 207-211)

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Key Principles: Labor

- Statutory priority for wages and employee benefit plan contributions would be updated and simplified
 - Statutory amount would be increased to \$25,000 per employee (indexed) and cover wage and benefit payments currently covered by sections 507(a)(4) and (5)
 - Earnings period would be eliminated
 - “First day” wage motion would not be needed unless payments were to be made above the per-employee cap

(Report, at 92)

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Key Principles: Labor

- Rejection of labor agreements under section 1113: Refinements would be added to the current statutory processes under section 1113(b) and (c) to more clearly separate the bargaining process from the litigation process in order to encourage negotiated resolutions where a debtor seeks changes to a labor agreement
- Retiree health benefits under section 1114: Resolving a split among the courts, the Report recommends that the debtor comply with the section 1114 process in all instances where a debtor seeks to modify retiree benefits, including where the debtor contends that the benefits may be unilaterally modified; however, the debtor’s use of the section 1114 process would not create any new claims arising from termination or modification of retiree benefits under section 1114

(Report, at 156-158, 166)

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Key Principles: Avoiding Powers and *In Pari Delicto*

- Heightened due diligence requirements for demand letters and pleading requirements for complaints
- Increase small claims defense to \$25,000 and venue provision to \$50,000
- Eliminate *in pari delicto* defense as to bankruptcy trustee only

(Report, at 148, 186)

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Key Principles: Avoiding Powers and Section 546(e)

- Narrow the section 546(e) safe harbor to exclude beneficial owners of privately issued securities in connection with LBOs
- Clarify that the exclusion from the safe harbors for transfers made with actual intent to hinder, delay, or defraud also applies to transfers made with similar intent that are voidable under applicable state law

(Report, at 95)

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Conclusion

- Principles intended to, among other things, create certainty and efficiencies in process
- Commission hopes that the Report will facilitate debate and meaningful dialogue concerning necessary and beneficial reforms to chapter 11

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